TAXATION AND THE B.C. FARMER

Published jointly by

Peat Marwick Thorne

Chartered Accountants

Province of British Columbia
Ministry of Agriculture and Fisheries
Hon. John Savage, Minister

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PREFACE

As a farm manager concerned with developing and maintaining a profitable business, you are faced with making many different kinds of decisions. In addition to operating decisions concerning production systems, marketing and credit, decisions with longer term implications must be made. These will relate to acquisition, organization and use of farming assets and the eventual transfer of the business through sale or otherwise to someone else.

The purpose of this publication is to assist farmers with tax planning strategies for the farm business. The material presented here should not be considered a complete interpretation or a replacement for the legislation as the tax laws are continually changing. If you have any specific problems not answered by this or other publications, you should contact your tax consultant or farm business advisor for further information, guidance and assistance.

Each farm business is unique in terms of physical characteristics, structure, income level and the size, ages and aspirations of the farm family. Consequently your tax planning and estate planning should be documented and analysed on its own merits in light of current legislation and may differ substantially from those of your neighbours.

Other material which may assist you in the tax planning area include "Farm Business Corporations in British Columbia", and frequent tax-related topics in the "Farm Business Management Factsheet" published by the Farm Management Branch. Also available is the publication "Estate Planning for the B.C. Farmer" published jointly by the Ministry and Peat Marwick Thorne, Chartered Accountants.

Although intended for use by farm managers in planning their business organization and tax management strategies, this publication is not meant to replace the "The Farming Income Tax Guide" published annually by Revenue Canada to assist with the filling out of income tax forms.

Derek Fryer, Partner
Peat Marwick Thorne
Chartered Accountants
Chilliwack, B.C

Terry Peterson, Director
Farm Management Branch
Ministry of Agriculture and Fisheries
Vernon, B.C.

January 1990

TAXATION AND THE B.C. FARMER

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INTRODUCTION

This publication was written for two very important reasons:

A. To stress the need for planning your tax affairs to accomplish your personal and financial goals within the boundaries of the law.

B. To assist in the communication of information about our tax laws to you and the persons who advise you in a professional capacity.

The first reason - planning - automatically gives rise to the second reason - knowledge of the tax laws. The problem is that the information that you require to plan your tax affairs is contained in several complex legal statutes and their regulations and in a mass of bulletins, circulars, jurisprudence and administrative practices. Few people have sufficient knowledge and experience in all these matters to advise you on how to organize and conduct your affairs so as to minimize your tax burden. You need a source of information dealing specifically with the tax problems that face farmers operating in this province.

You should be aware of the importance of planning and how your tax burden will be affected by the business decisions which you make. Hopefully, this layman's guide, which has been kept as brief and non-technical as possible, will help you do that.

Since the first edition of this booklet was released some very significant changes in the taxation field have occurred; the most recent being the extension of the capital gains deduction to quota, and the introduction of new rules relating to the valuation of purchased inventory where the farmer records a "cash-basis" loss. In some respects the planning decisions are now more complicated as a result of the changes in the federal income tax rules.

Tax law is not as constant, as it is ever-changing. Today's tax-planning strategies can become obsolete tomorrow because of changes in legislation. As most people are aware, hundreds of changes have occurred since Canada's income tax system was reformed in 1971. In 1987 there was another mini-reform. For most taxpayers this represented a mere tinkering of the existing system but, for farmers, there was a significant re-writing of some of the important rules.

It is hoped that the format established for this publication will enable further revisions to be made easily as the need arises. Up-to-date information on tax changes, in the hands of the people affected by them, is our major objective.

The response to this information has been most encouraging and indicates that there is a need for this type of information in the hands of people engaged in farming in this province.

The seventh edition incorporates changes made to the law up to January 1, 1990.

Derek J. Fryer
Peat Marwick Thorne
January, 1990

Chapter 1

FARMING - AS THE TAX MAN SEES IT

When is a farm a farm? As foolish as that question may seem it is a matter that has to be decided before you know where you stand under our various federal and provincial tax laws. This question assumes considerable importance, for example, when the owner of a farming business dies or transfers farm property to his child by way of gift. At that time, persons who have been in the business of farming may be entitled to receive preferential treatment at the hands of the income tax collector. It could mean the difference between paying no income tax at all or being taxed very heavily.

For purposes of real property taxation, classification of a particular parcel of land as farm land may have a considerable number of implications - not the least of which is a lower tax burden.

The Social Services Tax Act which authorizes the sales tax in British Columbia has a definition of a bona-fide farmer.

So, before proceeding with our study on tax laws relating to farmers, let's determine, if we can, exactly what farming means under the Canadian Income Tax Act. We will also review the requirements for classification of a parcel of real estate as farm land for real property taxation and discuss the meaning of a bona-fide farmer for the sales tax exemption.

The Canadian Income Tax Act

The Income Tax Act includes the following activities under the definition of farming:

A. tillage of the soil
B. livestock raising or exhibiting
C. maintaining of horses for racing
D. raising of poultry
E. fur farming
F. dairy farming
G. fruit growing
H. the keeping of bees

In addition to these activities which are specifically mentioned in the law, the following operations normally qualify:

I. the growing of Christmas trees and certain reforestation projects
J. nurseries and greenhouses
K. operating a wild game reserve
L. trading in race horses
M. certain feed lot operations
N. operation of a chick hatchery
O. certain market gardening operations.

An activity such as trout farming or other form of aqua-culture would usually qualify as farming. There may be other farming activities which would qualify. Farming does not include trapping, however, or employment under another person engaged in the business of farming.

As you can see, the income tax definition is very wide. It sweeps in just about every kind of activity to which an average person would apply the word farming. To be in the business of farming the person involved must be carrying on a particular farming operation with a reasonable expectation that he will earn a profit from it. This question becomes very important in determining whether or not a person is a bona-fide farmer, a hobby farmer (See Chapter 11) or just a person

farming for his personal use and consumption. Hobby farmers are in the business for a profit while people involved in agricultural activities only for their own needs are not.

Real Property Taxes

The words farm land and farm are defined under the Assessment Act, the legislation governing the levy of real property taxes in British Columbia, as "an area of land classified as such by the assessor". That appears to give a rather free hand to the assessment people, but some specific policy guidelines have been adopted by the government on this matter. A Farm Business Management factsheet available from the Ministry of Agriculture and Fisheries describes the specific standards that must be met if a parcel of land is to be classified as a farm for property tax purposes.

British Columbia Sales Tax

Whether or not a person is a bona-fide farmer will determine the application of British Columbia sales tax to certain farm implements and machinery. A bona fide farmer, for purposes of the exemption from sales tax, is tied to the status of the farm operation for purposes of real property taxation. The regulations to the Social Services Tax Act say that

> *a 'bona-fide farmer' means a person holding a farmland classification under the provisions of the 'Assessment Act'.*

It is worth noting that the foregoing rules will be more restrictive than the definition of farming for income tax purposes. It should also be noted that only certain farm supplies and machinery are listed as being exempt from the tax (a complete listing is available from any Social Service Tax Office).

That is a short summary of some of the definitions of farming contained in the various federal and provincial taxing statutes. The fact that the definitions vary from one set of laws to another means that you have to keep in mind which Act you are dealing with.

Chapter 2

ORGANIZATION OF THE FAMILY FARM

One of the most important questions to be answered in connection with the taxation of a farming business is the form of organization which should be used. Two farming operations may be identical in size, in value and in the amount of income they produce, yet they may be taxed very differently. The difference results from having different types of organizations under the law. In this chapter we will list the types of organizations which are commonly encountered and itemize some of their respective advantages and disadvantages. We will present a series of questions which should be answered by you in arriving at a wise decision as to the most advantageous type of organization for your particular farm. There are no easy answers to this problem. It is essential that all factors be taken into consideration in deciding which form of business organization is most appropriate to your particular circumstances.

First let's look at the types of organizations which are most commonly encountered. These are:

A. Sole Proprietorships
B. Partnerships
C. Corporations
D. Trusts and estates.

A. Sole Proprietorships

This is undoubtedly the most common type of business form in the farming community. The farm assets are owned by you as an individual (although sometimes the land is owned jointly by you and your spouse) and all the income produced by the business is reported by you in your personal income tax return. You are in the same position under the law as any other individual who carries on a business for himself.

The advantages of a sole proprietorship

1. Simplicity

   It's simple! There is a lot to be said for simplicity when it comes to tax planning.

2. Choice of fiscal year-end

   You can select any date as the fiscal year-end for your farming business and you are not required to report your income on a calendar year basis. For example, you might decide that January 31 is an appropriate year-end for your business. In that case, in your 1989 taxation year you would report your farming income for the fiscal period ended on January 31, 1989. If you commenced business on, say, June 1 of 1988, you would have only eight months' income to report in 1989, being the period June 1, 1988 to January 31, 1989. In 1990, you would report 12 months' income for the fiscal year ended January 31, 1990. Once a fiscal year-end is chosen it must be adhered to unless permission is given by the income tax authorities to change it.

3. Income-averaging methods can be utilized

   As discussed in Chapter 5, an individual farmer is presently able to use block averaging to reduce his income tax burden. This is being phased out, however, and will therefore have a limited impact on your future tax liability unless you are planning to sell your farm before 1994 (before 1992 in many instances) and have not block averaged since 1986.

4. Tax deferral on transfers of farm property

A tax-free rollover can be obtained on farm property (land, certain depreciable assets and eligible capital property (such as quota)) transferred to your descendants either during your lifetime or at the time of your death.

5. Life-time capital gains deduction on certain property

After 1984, you are exempt from tax on up to $500,000 of capital gains arising from the disposition of land and buildings used in your farming business (see Chapter 12). This exemption, which has recently been extended to farm quotas, applies whether the disposition occurs during your lifetime or at the time of your death.

6. Income splitting between husband and wife

A deduction may be claimed for wages paid to your spouse for employment services rendered to the business.

7. Principal residence

You can retain the principal residence status of your home. This is discussed in Chapter 10.

8. Unlimited drawings

There are no income tax limitations on the amount of cash which you can withdraw from your business. There will be limitations if the farm is incorporated.

The disadvantages of a sole proprietorship

1. Progressive rates of individual tax

Since you will be reporting all the income from your farm on your personal tax return you will be subject to tax at rates which, for 1989 in British Columbia, range from approximately 25% on the first dollar of taxable income to a high of approximately 45% on income in excess of $55,600. The top rate is less than it was in 1987 and previous years but it cuts in at a lower income level than it used to do and is still considerably higher than the rate applying in a corporation.

2. No limitation of legal liability

Persons who are unincorporated do not have a shield from legal action which, to a degree, is provided by a limited company. In a practical, day-to-day sense such protection may not make a great deal of difference to the majority of farmers.

However, if an incorporated farm encounters financial difficulties, the assets held outside the corporation could be protected from the claims of creditors except to the extent that the farmer has given his personal guarantee. If the farm is unincorporated no such protection is available, unless the farmer has purchased liability insurance.

3. Transferability of ownership is more difficult

If your business is a sole proprietorship, ownership of the assets such as real property, vehicles, equipment, registered livestock, etc., is recorded in your name. Transferring the ownership of such a business is more cumbersome than it would be if all the business assets were owned by a limited company. All that would be necessary to transfer the assets of a company-owned farming business would be to transfer the ownership of the shares of the corporation.

Certain assets such as livestock cannot be transferred by you to your children on a "rollover" basis if the transfer occurs during your lifetime. This is discussed in Chapter 15.

The capital gains deduction (see Chapter 12) will not apply to livestock and certain other assets owned by a sole proprietor. However, if the farm is owned by a family farm partnership or a family farm corporation, all of the accrued gain on the partnership interest or the shares of the corporation may be eligible for the capital gains deduction.

4. Employee benefits are not available

As a sole proprietor, you will be a self-employed person, so the fringe benefits applying to an employee are not available to you. Unemployment insurance will not be applicable either but, of course, Canada Pension Plan payments must be made. Self-employed people, farmers included, must pay both halves of the annual C.P.P. contribution.

5. Farm house expenses

As a sole proprietor you will be able to deduct expenses relating to a work area in your farm house (assuming it is your principal place of business) only to the extent of income from the farm. In other words, farm house expenses cannot increase or create a farm loss. Any expenses not deductible because of this rule may be carried forward indefinitely.

That, in brief, is a summary of the main advantages and disadvantages of the sole proprietorship or unincorporated farming business. Now we'll turn to another form of organization which involves more than one person.

B. Partnerships

Under pre-1972 tax law, partnerships were not given a great deal of recognition as separate entities for income tax purposes. The income earned by each partner of the business was taxable in the hands of the partner who had earned it, in a similar manner to the income from a sole proprietorship. Under current tax law, however, income for tax purposes must now be calculated primarily at the partnership level and is then allocated to the various partners. Certain expenses which are incurred by the partners in their own right (such as capital cost allowance on an automobile owned personally and used for business purposes) to earn their income from the partnership are deductible by each partner when he fills out his own tax return. It is fair to say that the new rules regarding partnerships have introduced an area of considerable complexity into our tax law. What was a very simple form of business organization for tax purposes is now not nearly so simple.

What is a partnership?

The Income Tax Act does not define what is meant by the term "partnership" but Revenue Canada has issued a statement which sheds some light on the matter:

> *Generally speaking, a partnership is the relationship that subsists between persons carrying on business in common with a view to profit. However, co-ownership of one or more properties not associated with a business (which under Common Law might be a joint tenancy or a tenancy in common) does not of itself create a partnership and this is so regardless of an arrangement to share profits and losses. For guidance on whether a particular arrangement at a particular time constitutes a partnership, reference should be made to the relevant provincial law on the subject and such law will be viewed as persuasive by the Department of National Revenue.*

It is very important to know whether or not a particular arrangement between two or more people will be a partnership for tax purposes. As indicated above, the joint ownership of property will not in itself indicate that a partnership exists. However, if two persons own a farm jointly and operate it actively together, sharing the net income or loss produced by the farm, there is a strong presumption that they are in partnership together.

If a farmer owns a farm property, but lets another person operate it on a share-cropping basis, he will not be considered to be in partnership. Instead, he will generally be considered to be earning property income as opposed to business income and his share-cropping receipts will be treated in the same manner as rental income.

Generally speaking, it is more difficult to demonstrate that a partnership exists between a husband and wife than say two brothers, a brother and sister, or two strangers. The reason for this is that where a husband and wife work together, there is usually a presumption that the sharing of work arises from their marital relationship rather than their desire to carry on as business partners. ***Because of this it is important that husbands and wives make it known to the people they do business with (such as their banker, their suppliers etc.) that they are carrying on business together.*** This relationship will be reinforced if they sign a partnership agreement.

Clearly, the facts of each situation will determine whether or not two or more persons are in partnership. This determination must be made before the income tax consequences of the arrangement can be sorted out.

The advantages of a partnership

1. Participation by two or more persons

   Two or more persons can participate in the business. Partnerships between corporations, between individuals and corporations and between you and your spouse are possible.

2. Choice of fiscal period-end

   The partnership may select a fiscal year-end for its business and each partner will then report his income from the partnership on that basis.

3. Income-averaging methods can be utilized

   Income from a farming partnership will retain its character as income from a farming business in the hands of the partner. As a result, block averaging can be

used. Use of the cash method of reporting income will also be available as long as all partners follow this approach.

4. Tax-free rollover of property to a Canadian partnership

Provided certain formalities are observed, it is possible for persons entering into a partnership arrangement to contribute property to the business without incurring an immediate tax cost. An example might be a piece of farm equipment which the partnership will require to carry on its business. If the machinery is transferred to the partnership at fair market value a capital gain might arise which could result in income taxes. If, however, the machinery is transferred at its value for tax purposes (undepreciated capital cost, in this case), the gain is deferred until such time as the partnership disposes of the asset.

5. Tax-deferred rollover of partnership interests

The tax-deferred transfer of an interest in your farming partnership to your descendants is available during your lifetime or at death.

6. Life-time capital gains deduction on the sale of the partnership interests

You and your partners will each be exempt from tax on the first $500,000 of capital gains arising from the disposition after 1984 of their interests in a family farm partnership (see Chapter 12). This exemption applies whether the disposition occurs during your lifetime or at the time of your death.

7. Income splitting between husband and wife

A deduction may be claimed for wages paid by the partnership to your spouse for employment services rendered to the partnership. If you and your spouse are partners, the partnership arrangement itself will result in income splitting.

8. Principal residence

The principal residence status of your family home can be preserved.

9. Partners' drawings

There are no income tax restrictions on the amount of cash that can be withdrawn from the business. If in a particular year the amount withdrawn exceeds the profit on which you are subject to tax, there are no immediate tax consequences. There will be consequences, however, if at the date you cease to be a partner in the partnership your accumulated drawings exceed your accumulated profits.

The disadvantages of a partnership

1. No protection from the progressive rates of individual tax

The same comments made in connection with the taxation of income from a sole proprietorship apply here.

2. No limitation of legal liability

A sole proprietor has no protection from legal action which could be launched against him. A member of a partnership, in most cases, is not only liable for his

own actions but is also jointly liable for the actions of his business partners. So choosing your business partner is not something to be entered into lightly!

3. Additional complexities

A partnership is a more complex arrangement than a sole proprietorship. Additional accounting information will have to be recorded each year so that you and your partners will be able to determine the tax value of their interests in the partnership.

C. Corporations

A corporation is a separate legal person and is treated as such under our federal and provincial laws. The owner of Greendale Farms, for example, may decide to incorporate by selling the assets of his farm business to a limited company which his lawyer has set up for the purpose of carrying on the business. Instead of having just one person involved in the business (the farmer) we now have two (the farmer and the corporation). The corporation carries on the business and the farmer becomes the shareholder and perhaps an employee as well. Depending on the manner in which the corporation is organized and the objectives of the incorporation, the farmer's wife and children may also be shareholders and/or employees.

As far as the day-to-day operation of the farm is concerned, not a great deal will appear to have changed. The farmer will carry on his farming activities just the same as before. But a closer look will reveal that certain details have changed. For example, purchases and other expenditures will now be made in the name of Greendale Farms Limited rather than Greendale Farms. Sales of farm products will also be made in this name and a bank account will have been opened in the name of the corporation. The annual notice for property taxes will be made out in the name of the corporation instead of the farmer as an individual. All these things are indications to the world at large, and, most important, to the tax collector, that the farming business is now owned by another person - a corporation named Greendale Farms Limited.

The advantages of a corporation

1. Limited liability

The exposure of assets to legal action is an important consideration in choosing a form of business organization. If a corporation is used it is only the assets held by the corporation which will be exposed to the risks of the business. Such protection is not afforded by a sole proprietorship or partnership. It is worth noting, however, that it is not uncommon for financial institutions to require an incorporated farmer to issue a personal guarantee in respect of his corporation's bank loans. If that happens, the farmer loses his limited liability - at least in respect of that particular debt.

2. Ease of transferability

To transfer ownership in an incorporated farming business, all that has to take place is the transfer of shares in the limited company. For an unincorporated business to be transferred, ownership of all the individual assets would have to be changed.

In some situations, the use of a corporation can make it easier for you to achieve your estate planning objectives - particularly where there are several non-farming children. By setting up the appropriate kinds of shares, it is possible for you to do the following:

a) transfer future growth (and some or all of the control) of the farm to your farming children;

b) give your non-farming children an interest in the farm that will not allow them to interfere in the running of it; and

c) if necessary, retain overall control by holding a special class of non-participating shares which carry the majority of the votes.

This is discussed in more detail in the publication entitled "Estate Planning for the B.C. Farmer" published jointly by the Ministry of Agriculture and Fisheries and Peat Marwick Thorne, Chartered Accountants.

3. Permanence

Unlike a natural person, a corporation can live forever. It will cease to exist only if it fails and its creditors have its affairs wound up or if it is struck off the register held by the Registrar of Companies in Victoria because statutory requirements have not been met. The corporation could also be done away with if the shareholders decide to liquidate it.

4. Greater flexibility in tax planning

A corporation will be subject to tax under rules which are somewhat different from those which apply to unincorporated businesses. ***It is a fair generalization to state that the use of a corporation will make your overall tax position more complicated but it also opens up two important avenues which might not otherwise have been available.*** Very briefly they are:

a) Greater ability to defer taxes on farming income.

If a corporate farm earns more income than you need to live on, the extra income can be retained in the corporation and re-invested in the farm.

Under current income tax rules this additional income (up to a maximum of $200,000 each year) will be taxed in the corporation at a combined federal-provincial rate (ignoring surtax) of only 21%. This rate will often be considerably less than the rates that would have applied had the income been earned by you as a sole-proprietor or a partner in a partnership. Admittedly, you will probably be subject to a further tax when you withdraw the additional income from the corporation in the form of a dividend, but this tax is deferred until the dividend is actually paid.

It is important to remember that the opportunity for tax deferral arises only if you are able to leave some of your profits in the corporation. If you need to withdraw all of your profits in the form of a wage or a dividend, there will not be a deferral and the total tax that will be paid by you and the corporation will be approximately equal to what you would have paid if you had remained a sole proprietor.

b) Greater ability to split income between you and your spouse.

5. Tax-deferred rollover of a property to a corporation

It is possible for you to transfer most of your business assets to a corporation without incurring tax provided the transaction is structured properly. The tax

which would otherwise arise is deferred, either in whole or in part. Certain technicalities must be complied with if the rollover is to be obtained, but in most cases the incorporation can be carried out without difficulty.

6. Choice of fiscal year-end

The year-end for the corporation can be selected in much the same manner as for a sole proprietorship or partnership. Corporations have slightly different rules, however, in that a corporate fiscal year could be 53 weeks long in some cases.

7. Tax-deferred transfer of shares in the family farm corporation

The shares of a corporation which meets the definition of a family farm corporation will usually qualify for a deferral of income tax when they pass from one generation to the next. This will apply both during the owner's lifetime and at the date of death. See Chapters 14 and 15 for the rules which apply.

8. Life-time capital gains deduction

Capital gains realized on the disposition of shares of the capital stock of a family farm corporation are eligible for the lifetime capital gains deduction (see Chapter 12). This applies whether the disposition occurs in your lifetime or at the time of your death.

In theory, this offers you an advantage in that the accrued gain on assets such as livestock in effect become eligible for the capital gains deduction, provided they are owned by the corporation and contribute to the value of its shares. ***In real life, however, it is often much more difficult for you to sell the shares of your corporation to a person outside the family because the purchaser wants to buy the individual assets.*** A partial solution to this problem may be for you to hold your land and buildings outside the corporation. The property would continue to be eligible for the capital gains deduction. It would also be eligible for the tax-deferred rollover to your children provided it is rented to a family farm corporation for use in its farming business. There may be a reduction in the annual capital cost allowance on some of the buildings (because they would become rental assets rather than assets used in a farming business), but this may not be a serious problem. Conceivably, if quota was held outside of a corporation, it may still qualify for the capital gains deduction. Whether this arrangement is possible will, to some degree, be dependent on the rules of the various agricultural marketing boards and the arrangement between the farmer and his corporation. Clearly you should receive expert advice before attempting to set up this type of arrangement.

If you own land and buildings on which there is already a substantial accrued capital gain, you may wish to transfer your farm to a corporation to "lock in" your entitlement to the capital gains deduction on this accrued gain. You will then be protected if at a subsequent time the government decides to withdraw the capital gains deduction. This is discussed further in Chapter 12.

If you decide to "lock-in" your capital gains deduction in this manner, you must remember that any future increase in the value of the land and buildings can be realized on a tax-free basis only if you are able to sell shares of your company. As mentioned above this is not easy to do.

The disadvantages of a corporation

1. Greater start-up costs and on-going administrative costs

The cost of incorporating a limited company, filing annual reports, preparing corporate tax returns and various other legal requirements will add to the cost of carrying on a farming business by means of a corporation.

2. Loss of five-year block averaging for farming income

The special income-averaging method available for the farming income of a sole proprietor or member of a partnership is not available if the farming income is earned by a corporation. This is not a particularly important matter since block averaging is now being phased out.

D. Trusts and Estates

As a general rule, a farming business would usually be operated by a trust only in situations where the owner of the farm had died and left the business in trust under his will. A practical example might be the situation where a farmer dies leaving a widow and several children. The farm could be left to a trust in such a way that the widow would receive the income of the farming business for the rest of her life. When she died, the farm property would be divided among the surviving children. We will not deal with farms operated by trusts and estates in any detail here since their income tax treatment can become quite involved and warrants a separate study in itself. ***On the whole, the average farmer will not find the use of a trust a convenient form of organization through which to carry on his farming activities.*** Trusts may be useful, however, in some of the more sophisticated and complex tax planning arrangements.

QUESTIONS TO CONSIDER WHEN SELECTING THE FORM OF BUSINESS ORGANIZATION

Now that we have examined the forms of business organization, let us outline some of the practical questions you should ask yourself in arriving at a wise choice as to your form of organization. Some of the most important questions which should be answered include the following:

A. What is the expected level of annual farm income, at present and in the future?

This is a key factor in determining whether or not it is advantageous to use a corporation. As mentioned previously, there is an opportunity to defer income taxes but the benefit arising from this deferral will depend on the extent to which the farm generates income in excess of your needs. If you need all of the income generated by the farm there will be no deferral of tax because the income earned by the corporation will be fully distributed each year in the form of salaries or dividends.

Not only should you be able to leave some of your profits in the corporation, the savings that result from this must be sufficient to recover the additional on-going administrative costs of running a company (which, depending on the circumstances could be as much as $1,500 per year) and the start-up costs which could be as much as $5,000, or more.

If the farm has a high debt load, the income tax that is deferred in a corporation can be used to pay down the debt at a faster rate than would have been the case had the business continued as a proprietorship. This will result in interest savings that could be substantial in some cases.

B. Will the farm be passed to the next generation?

Our federal income tax law permits you to transfer land, certain depreciable property and eligible capital property (such as quota) used in a farming business to your descendants without any immediate tax liability. The transfer can be made during your lifetime or, on your death, under your will. As long as the farm property is used by the family in the business of farming it can pass indefinitely from one generation to the next with no tax arising.

There is an even broader rollover available in respect of an interest in a family farm partnership or shares of a family farm corporation. Using these forms of business organization it is possible for you to transfer livestock to your children on a tax-deferred basis during your lifetime. This is not possible if you carry on your business as a proprietorship. If you are a sole proprietor you can, however, transfer your livestock to your children on a rollover basis on your death (see Chapter 14).

C. What types of assets do you own?

When planning the type of organization to use, consideration must be given to the types of assets which you own. Because different assets receive different tax treatment it may be desirable to hold certain assets personally and other assets through a partnership or corporation. (The family home, for example, should be owned personally to ensure that you can use the principal residence exemption.)

D. Are there many non-farming children?

In some situations, a major factor in determining the appropriate business organization will be the manner in which it will facilitate the transfer of the farm to your children. If there are a number of children, some of whom are not working on the farm, a corporation may make it easier for you to treat all of your children equitably while allowing your farming children to continue to run the farm.

E. Is there likely to be an arm's length sale of the farm in the near future?

If there is, your ability to claim the capital gains deduction will be important. Quite possibly, your ability to use the deduction effectively will be limited if you transfer your farm to a corporation. Whether or not this is the case may depend to some extent on your ability to sell the shares of your company rather than causing it to sell its individual assets. ***This will be a very important issue - perhaps the most important in many cases.***

F. Are you willing to complicate your affairs or make them less flexible so as to minimize taxes or achieve estate planning objectives?

To what extent are you willing to disrupt your present situation, and possibly make it more complicated and less flexible, so as to reduce your tax burden or achieve estate planning objectives? Will such changes be worth the cost? This is perhaps the most important question of all. A change in the farm organization should never be made solely in the interest of tax savings without also looking at the practical consequences of the reorganization. Your accountant or lawyer might suggest a change which could reduce your tax burden but you might be reluctant to depart from the tried and true approach with which you are familiar. Your reluctance should be respected. On the other hand, some farmers may be very aggressive in seeking out new ways in which they can reduce their income taxes, during their lifetime and at time of death. The great majority of people probably fall somewhere between these two extremes. The point of this discussion is simply that you and your professional advisors should both have a clear idea of what

changes are practical and whether your best interests are served by making them. In assessing whether your interests are being well-served, the adviser should have an understanding of what you will be comfortable with.

Because a corporation is a less flexible arrangement than a partnership or a proprietorship, it is generally <u>not</u> advisable for an unincorporated farmer to form a corporation unless the benefits are significant and cannot be achieved in any other manner.

The Ministry of Agriculture and Fisheries booklet, "Farm Business Corporations in British Columbia" should prove useful to you if you wish to further pursue the ramifications of the various forms of organization. You might also want to review "Estate Planning for the B.C. Farmer" published jointly by the Ministry and Peat Marwick Thorne, Chartered Accountants.

Chapter 3

WHAT YOU SHOULD KNOW ABOUT THE CASH METHOD OF ACCOUNTING

What is the cash method?

If you are a person who is already in the business of farming you probably have been using this method to report your farm income since you began. It is basically very simple. You include in your income only those amounts you have actually received in the year and you take as deductions only those expenses which were actually paid for in the year. In addition you claim capital cost allowance, an income tax term for depreciation expense, up to the prescribed maximum amounts allowable for the various classes of depreciable assets which you own. You also write off expenditures that you have made subsequent to 1971 on intangible assets such as quota (see Chapter 9). No accounting has to be made for accounts receivable and no deduction can be taken for any unpaid bills which you might happen to have on hand at the end of the fiscal period.

If you are a farmer who operates on a profitable basis, the above comments summarize all of the accounting rules that you will need to know. If, on the other hand, you operate on a break-even basis, or perhaps at a loss, the system is not as straight-forward and you will need to be aware of the rules dealing with inventories.

The inventory rules are in two parts. First, there is a mandatory rule that applies whenever you report a cash-basis loss. This rule (referred to as the mandatory inventory adjustment) came into effect for the first time in taxation years commencing after 1988. The second inventory rule, which is optional, has been in the Income Tax Act for many years and enables you to average your income from one year to the next.

The mandatory inventory rule

For many years the government has been concerned about farmers who inflate their cash-basis losses by purchasing livestock or supplies immediately before their year-end. These losses could be offset against non-farm income to reduce the farmers' tax liabilities.

Initially the government decided to deal with this situation by requiring all farmers to change their basis of accounting. After much discussion, it was persuaded that this would unduly complicate the accounting for all farmers and it should therefore deal with the problem more directly.

This is exactly what the government did. Unfortunately, it has added considerable complexity to the system but at least these additional complications will be faced by only a part of the farm sector and not by all of it.

Conceptually, the new rule is not difficult to understand. ***If you record a cash-basis loss in a taxation year commencing after 1988, you must reduce that loss by the value of your purchased inventory at the end of the year.*** The term "inventory" is defined so as to include livestock (other than animals in your basic herd) as well as feed and fertilizer etc. Because you are required to make this adjustment if you realize a cash basis loss, it is called a mandatory inventory adjustment or MIA.

The MIA that is made in one year is deductible in the following year and forms part of the cash-basis income/loss for that year. The amount of the MIA for a particular year cannot exceed the loss for that year - so it will not convert a loss into income.

The new rule can be illustrated conceptually as follows:

		Year 1	Year 2
Assume:			
"Value" (eg: lesser of cost and fair market value) of purchased inventory on hand at the end of the year			
livestock		$ 20,000	$ 25,000
feed etc		5,000	6,000
		25,000	31,000
Cash basis (loss) income for the year		(30,000)	50,000
Then, the income (loss) for tax purposes will be calculated as follows:			
Cash basis (loss) income for the year		(30,000)	50,000
MIA adjustment from previous year		N/A	(25,000)
		(30,000)	25,000
MIA, end of year			
Loss	30,000		
"Value" of purchased inventory	25,000		
Lesser amount		25,000	N/A
(Loss) Income for tax purposes		$ (5,000)	$ 25,000

So far, the MIA does not appear to be overly complicated but now we have to take a brief look at some of the details. Included in these details is a set of "transitional rules" that will apply for the first seven years of the new system. These rules are necessary because future MIA adjustments are going to be affected by the value of purchased inventory acquired by you before the new rules came into effect. The government concluded that the maximum MIA should be reduced to reflect this fact; so this is why we have these transitional rules.

The additional "details" of the MIA system are summarized below:

A. ***For most farmers, the "value" of their purchased livestock will be the lesser of their original cost or their fair market value. This means that farmers will have to keep track of which animals were purchased and the amount paid for them.*** As discussed below, they may need additional information as well, if they are to optimize their use of the transitional rules.

B. ***Certain livestock (called specified animals) are treated differently.*** Specified animals include all horses and those animals which the farmer elects to treat as specified animals and which are bovine livestock (eg. ox-like animals) registered under the Livestock Pedigree Act.

For purposes of the MIA, the "value" of specified animals is determined on an individual animal basis by reference to its original cost. To calculate the "value" of a particular animal its original cost is depreciated on a reducing balance basis at the rate of 30% per annum. The original cost is reduced if the animal was purchased more than one year before the commencement of the new system. In the event your accounting period is less than a full year, the depreciation is reduced accordingly.

So, if a farmer has horses, or has pedigree cattle which he elects to treat as specified animals, he will not only need to keep track of the cost of each purchased animal - but also the date on which it was acquired and its depreciated value.

Most of the rules described above can be illustrated if we use the hypothetical example on page 15 and change a few of the assumptions.

Let's now assume the following:	Year 1	Year 2
Farmer commenced business on July 1, in Year 1		
# of days in the fiscal period	184	365
Cost of "specified animal" purchased July 1 and still on hand at the end of year 1 and year 2	$ 10,000	$ 10,000
"Value" of other purchased inventory on hand at the end of the year		
livestock	20,000	25,000
feed	5,000	6,000
	25,000	31,000
Cash basis (loss) income for the year	(40,000)	30,000
Then, the "value" of the specified animal for purposes of the MIA will be calculated as follows:		
Original cost	$ 10,000	
Depreciated cost from previous year	-	$ 8,488
	10,000	8,488
Less depreciation (30% - pro-rated based on the number of days in the year)	1,512	2,546
"Value" for purposes of the MIA	$ 8,488	$ 5,942
Then, the income (loss) for tax purposes will be calculated as follows:		
Cash basis (loss) income for the year	$ (40,000)	$ 30,000
MIA from previous year	N/A	(33,488)
	(40,000)	(3,488)
MIA end of year		

Year 1		
Loss	40,000	
"Value" of purchased inventory	25,000	
"Value" of specified animal	8,488	
	33,488	
Lesser amount		33,488

Year 2

Loss	3,488		
"Value" of purchased inventory	31,000		
"Value" of specified animal	5,942		
	36,942		
Lesser amount			3,488
(Loss) Income for tax purposes		$ (6,512)	$ NIL

C. There are two transitional rules that apply in the first seven years. The basic rule (called the "fixed dollar" rule), which applies automatically unless you choose the elective rule (see D below), reduces the MIA by a fixed dollar amount, as follows:

Year 1	$ 15,000
2	12,500
3	10,000
4	7,500
5	5,000
6	2,500
7	Nil

Year 1, of course, is the first year commencing after 1988. ***The effect of this rule is to allow you to report a loss at least equal to the amount of the "fixed dollar" adjustment.*** In other words, in year 1, you will have a cash-basis loss of at least $15,000 even if the "value" of your purchased inventory exceeds your loss. This may be illustrated as follows:

Assume:

Cash basis loss	$ (35,000)
Purchased inventory on hand at year-end	
original cost	40,000
fair market value	50,000

Then, the loss for tax purposes is as follows:

Cash basis loss		$ (35,000)
MIA - lesser of		
(i) loss	35,000	
(ii) value of inventory (lesser of cost and fair market value)	40,000	
lesser amount	35,000	
less fixed dollar transitional rule	15,000	20,000
Loss for tax purposes		$ (15,000)

D. The second transitional rule (the elective one) allows you to restrict your MIA in respect of the animals that are on hand at the end of the year in question and were also on hand at the beginning of the new system. The amount of the adjustment is expressed as a fraction of the "value" of such animals:

Year 1	1/7
2	2/7
3	3/7
4	4/7
5	5/7
6	6/7
7	7/7

Clearly, this transitional rule involves more record-keeping because it requires you to keep a separate account of the cost and fair market value of two groups of purchased animals - those on hand at the beginning of the new system and those purchased subsequently. However, if you have a significant purchased inventory going into the new system you will likely find it worthwhile to maintain those records because your MIA will be lower and your losses will be higher.

You will be affected by the MIA if you had intended to offset your farm losses against non-farm income or to carry them back against incomes of previous years. If you are in this position, you should be considering whether your records are sufficient to allow you to calculate your MIA. You might also consider whether you will likely want to use the elective transitional rule. If you own pedigree cattle which you could elect to treat as specified animals, you should consider the impact of making this election.

The optional inventory rule

For many years, the Income Tax Act has permitted you to include in your farming income for a particular year any amount up to the fair market value of your livestock, other than basic herd animals, owned at the end of the year. For 1988 and subsequent taxation years, this rule has been altered in two respects:

first, the rule now applies not only to livestock but to other inventories as well, such as feed and fertilizer; and

second, the amount that can be added to income is reduced by the amount of the MIA described above.

To illustrate how the above rule works, let's assume your farm statement is as follows:

Farm receipts for the year	$ 86,000
Farm expenditures for the year, including cattle purchases of $12,000	88,000
Cash loss from farming operations	$ (2,000)
Year-end inventory:	
Original cost of livestock	$ 12,000
Fair market value of entire herd (excluding the "basic herd")	$ 25,000

If we look first at the MIA (because this will affect the maximum optional adjustment), and we ignore the impact of the transitional rules, we find that the adjustment is $2,000. This means that the adjusted cash-basis loss is NIL.

You now have the option of taking a further amount from $1 to $23,000 and adding it to your income. This $23,000 represents the value of your entire herd minus the $2,000 that you have already been obliged to add to your income as a MIA adjustment. In other words, you have a choice of reporting as the final figure on your tax return an income between NIL and $23,000. The amount of the inventory value which you add to income in one year must be deducted from the income you report in the following year.

But wait a minute, you might say. What advantage is there to doing that? Won't this just put you in a position where you will have to pay income tax? Perhaps, but consider these reasons:

A. If a farmer who is building up his herd over a period of years incurs losses for more than ten years (five years for losses incurred before 1983), he will lose the chance to deduct these losses against future income. His 1986 loss, for example, must be deducted from income by 1996 or it is gone forever. ***By placing a value on your livestock inventory which will reduce each year's loss to nil, you can avoid this time restriction on using your tax losses.*** The losses are, in effect, converted into inventory values which can be carried forward indefinitely (provided you continue to own the herd) and can be deducted in any year in which you make a profit.

   Of course, now that we have a mandatory inventory adjustment that will eliminate or reduce cash-basis losses to the extent there is purchased inventory on hand - there will be fewer opportunities to use the optional adjustment to convert losses to inventory values. However, there may be situations where the mandatory rules do not apply (because there is no purchased inventory) or you want to use up losses that were incurred before the MIA came into effect.

B. ***Another important consideration is to ensure where possible, that you utilize the non-refundable tax credits that are available to you.*** Assume for instance, that these credits amount to $2,500 and the effective federal/provincial tax rate in the first tax bracket is 25%.

   If you report no income, these credits will be lost entirely. You can avoid this hardship simply by adding to your income $10,000 in respect of your ending livestock inventory. Your net income from the farming business will then be changed to $10,000. Your tax liability will be $2,500 but it will be offset by your non-refundable tax credits. You will have no tax to pay but you will have preserved $10,000 of deductions for a time in the future when you have cash income which is subject to tax.

C. Under the Canada Pension Plan, persons such as farmers who are self-employed are required to contribute up to a maximum of $1,148 in 1990. This contribution level is based on a maximum of $28,900 self-employed earnings in the year. If you earn less than $28,900 in 1990 then your contribution is also less. A farmer who reports a loss does not make any C.P.P. contributions. Keep in mind, though, that the benefits a person (or his dependents) will eventually receive from our national pension scheme are based strictly on the amount of the contributions which he has made. If there are no contributions, there are no benefits either. For this reason, you may wish to ensure that you report net self-employment earnings each year which are at least equal to the C.P.P. maximum earnings. This will ensure that the maximum benefit will be paid when you cease to pay in and start to collect instead. The amount of the maximum earnings has been increasing in recent years so in planning the amount of your farming income you should always check to see what the C.P.P. maximum earnings is for the current year. Your income tax form or T1 guide will have this information.

D. Contributions to registered retirement savings plans are also governed by the level of the contributor's earnings. The maximum annual contribution in 1990 is generally the lesser of $7,500 and 20% of the contributor's "earned income" (which includes farming profits). On this basis, you will be able to make the maximum contribution to your plan if your farming income is $37,500 or higher.

We have mentioned only four reasons why you might wish to adjust the level of your income for tax purposes by taking in a portion of the value of your year-end inventory. In particular situations, there may be other reasons as well.

If tax returns for prior years have been filed without using this livestock adjustment you should ask Revenue Canada for permission to revise the years which are still open for reassessment so as to use up non-refundable tax credits (or claim personal exemptions for years before 1988) and eliminate losses. Legally Revenue Canada can refuse this request but they do permit adjustments in some situations. There is nothing to be lost by trying.

We should also mention that the amount of capital cost allowance which is deductible by you can be varied within limits and this too can be used to adjust income to the desired level.

Who can use the cash method?

According to the income tax rules dealing with the computation of business income, only persons who have income from a farming or fishing business can use the cash method. The word "person" in this context includes individuals, corporations, partnerships and trusts.

Once you commence to use the cash method you must continue using it in the future. Permission to switch to the accrual method, the basis used by virtually all other taxpayers who earn business income, must be obtained from the tax authorities. If two or more persons operate a farm jointly they each must use the same method to report their farming income.

Interestingly enough, you do not need permission from Revenue Canada if you want to switch from the accrual method to the cash method. All you have to do is to begin filing tax returns using the cash method, ensuring that all proper accounting adjustments have been made.

Chapter 4

CAPITAL GAINS AND VALUATION OF A FARMER'S PROPERTY

A. What you should know

The most significant change brought about by Canada's 1971 tax reform was the introduction of tax on capital gains. Virtually every Canadian who owns property was affected by this broadening of the tax base. For most Canadians, the tax base has now been narrowed again by the new lifetime capital gains deduction. ***However, because this deduction is limited (see Chapter 12) and there is the possibility that a large capital gain will bring the "Alternative Minimum Tax" rules into play (see Chapter 13), the measurement of capital gains continues to be important.***

Since 1971, Canadians have gradually become accustomed to using the phrase "valuation day" or simply "V-day" to describe the day from which the capital gains on property owned before 1972 are measured. ***Essentially, capital gains realized after 1971 from the sale of property owned before 1972, will be taken into account for tax purposes only to the extent that such gains exceed the gain that accrued prior to V-day.*** If there is a post 1971 gain, only three-quarters (described as the taxable capital gain) is subject to tax in 1990.

Assume for a moment that a farmer owns land that cost $50,000 in 1960, had a V-day value of $125,000 and is sold in 1990 for $225,000. The total gain is $175,000 but the amount that is taken into account for income tax purposes is the gain that accrued after V-day which is only $100,000. Of this gain, only three-quarters is subject to tax so the taxable capital gain is $75,000 (3/4 x $100,000).

Of course, there are similar rules dealing with capital losses. Only three-quarters of post-1971 losses (described as allowable capital losses) are deductible from income in 1990.

The three-quarters fraction referred to above was only two-thirds in 1989. For individuals, the increase in the inclusion rate took effect January 1, 1990 whereas for most farm corporations, the increase became effective in taxation years ending after 1989. For those corporations with non-calendar year ends, the inclusion rate for the taxation year that includes December 31, 1989 is determined using a formula that takes into account the number of days in calendar 1989 versus calendar 1990.

Taxpayers (including partners in a partnership) may deduct their allowable capital losses from taxable capital gains realized in the same year. To the extent they are not utilized they may generally be carried back three years and carried forward indefinitely. Individuals who are carrying forward net capital losses which were incurred prior to May 23, 1985 may deduct up to $2,000 of such losses from their other income each year. There are certain capital losses called allowable business investment losses which may be carried forward for seven years and applied against any type of income. If these losses are not used in that seven year period, they become ordinary capital losses and may be carried forward indefinitely to be applied against taxable capital gains.

The amount of the capital gain or loss that an individual (or a partner in a partnership) will realize as a result of selling a property owned prior to 1972, may vary depending on whether the individual uses the "neutral zone method" or the "V-day method" of computing his capital gains and losses. These two methods are often referred to as the "transitional rules". Usually there will be a difference in these methods only where the V-day value is less than original cost or where the eventual sale price is less than the V-day value. These circumstances are relatively rare so this is not a matter that will be of much concern to the average farmer. The V-day method can be used only if an election is filed with the tax return for the first year in which a pre-1972 property was sold at a profit.

Having selected the V-day method for the first pre-1972 property sold, it must be used for all pre-1972 properties. If the V-day method election is not filed, the neutral zone rules apply automatically.

Setting aside the transitional rules, the immediate implications of a tax on capital gains are fairly simple. If you owned capital property at V-day or acquired property after that date, it is almost certain that at some point you will dispose of that property for proceeds which are either greater or less than V-day value or cost. The resulting capital gain or loss may result in a tax cost (depending on the availability of the capital gains deduction) or tax saving when your tax return is filed for the year in which the disposition is made.

What is capital property?

The capital property of a farmer usually includes the following types of assets:

1. Farm land and improvements such as drainage and fences
2. Buildings
3. Machinery, equipment, vehicles
4. Farm homes
5. Shares of a farm corporation or an interest in a farm partnership
6. Stocks, bonds and other securities
7. Personal use property such as boats, summer cottages, automobiles
8. Certain items specified as listed personal property:
   coins, stamps, rare books, jewelry, drawings, paintings or sculpture.

If you owned any of these types of assets at the end of 1971 you will have to determine their V-day values. This applies irrespective of which transitional rule you decide to use. You will also have to determine the V-day value of the following properties which you owned at the end of 1971:

1. Basic herds
2. Milk quotas or other government rights or licences of this nature.

If you have acquired capital property since V-day, you are required to maintain accurate cost records.

What is a disposition of capital property?

Obviously, it includes the sale of property to someone else, but it also includes a lot of other transactions as well. You should be aware that a disposition will occur (and the capital gains rules may apply) when the following events occur:

1. Property is sold;
2. Property is gifted;
3. The owner of the property dies;
4. Property is taken unlawfully;
5. Property is expropriated;
6. Property is destroyed and insurance proceeds are received;
7. Property is transferred to a trust, corporation or partnership;
8. A marriage breakdown occurs and a division of property is made pursuant to the Family Relations Act.

Again, our list is not a complete one but it covers most of the more common situations. A disposition of capital property is deemed to occur immediately prior to a person's death so, in all cases, there will be a disposition of some kind in the lifetime of every individual who owns capital property. ***Farmers, as we shall see later, receive special consideration on the disposition of most farming assets to their children in that***

they can arrange for the transfer to take place on a "rollover" (tax-deferred) basis. The existence of this special treatment does not eliminate the need for a V-day valuation because the effect of the "rollover" is only to postpone taxes, not to forgive them.

Of course, farmers now have the capital gains deduction and, unlike many other taxpayers, they are entitled to an exemption from tax on $500,000 of capital gains if they realize a capital gain from the disposition of qualified property (see Chapter 12). However even this development does not remove the necessity of obtaining a V-day value. You still need to calculate your capital gains so that you can determine if your capital gains deduction will cover them. You also need to determine if the new alternative minimum tax rules apply (see Chapter 13).

B. Why you should establish your V-day value NOW

First, it is necessary to be aware of the significance that valuation day values and cost records have in determining a person's tax liability. There is a tendency to put off determining these values since there is no need to report them to the tax authorities until a disposition of the property takes place. And that might not be for years and years. But the time to establish a V-day value is as near as possible after V-day because the difficulty of doing it grows with the passing years. Consider these factors:

1. Inflation. Farm asset values have risen since V-day and will probably continue to do so. For some assets, such as real estate, values are changing constantly. Establishing what the value was at a particular time becomes more difficult if values are subject to changes in local conditions.

2. Documentation. Documentation which can provide support for asset values at December 31, 1971 is still available but as time goes on this sort of evidence, such as news articles, advertised prices for assets similar to yours etc., becomes much more difficult to obtain. Consider, for example, the list prices and trade-in values for farm machinery.

3. Photographs. These may be important to portray the condition of an asset at or near valuation day. Pictures can be of great assistance in cases where an asset changes over a period of years. An example might be a parcel of land adjacent to a deep gully in which serious erosion was taking place. The land might have had considerable value at V-day but be virtually useless as farm land at the date of disposition many years later due to the erosion. A photograph taken near V-day could provide excellent support for a higher V-day value.

4. Information regarding neighbouring properties. This can be very useful. Keeping a record of nearby properties or properties similar to your own in the same area, and what they sold for, provides important guidelines for the value of your own property. It is much easier to compile this information if you do it now instead of many years in the future.

5. Knowledgeable persons who can provide information or opinions. Who knows more about his farm than the farmer himself? But if he dies without leaving behind the benefit of his knowledge in writing then the value of his intimate knowledge of the farm will be lost. Persons with a working knowledge of real property values in your area at December 31, 1971 also pass from the scene. Getting a letter of opinion from them now might be something which is not possible when the need for the letter arises.

6. Getting an appraisal. The foregoing comments apply to farmers who wish to establish their own V-day values rather than having a formal appraisal done by a professional appraiser. Appraisals cost money but are important in cases where your property is substantial in value. Farmers with property whose V-day value is significant might be well advised to get a formal appraisal. The appraiser's job is a difficult one, but it will never be any easier than it is now.

7. Estate settlement. The handling of a person's estate will be considerably expedited if the deceased person has V-day values on hand for all his capital property. It is something that should be taken almost as seriously as making a will.

A special note regarding rollovers of various forms of farm property

The rules regarding rollovers for farm property are discussed in Chapters 14 and 15. The general concept of the rollover provisions is that the recognition of a capital gain or the recapture of capital cost allowance is deferred. Tax will not be payable until the farm property ceases to be passed from one generation to the next. It is possible that a family farm, family farm corporation or an interest in a family farm partnership could be handed down from father to son for a hundred years before there is a taxable disposition. Who will be around in the year 2090 to say what the property was worth on December 31, 1971? ***Do yourself and your family a favour by taking steps NOW to establish V-day values for your property. Having done that, put the valuation in a safe place and make sure your family knows where it is.***

C. How should you go about determining valuation day values?

You can either call in a professional appraiser to do the job or you can do it yourself. The cost of getting an appraisal could amount to several hundreds or thousands of dollars and you should be aware that such an expenditure is not deductible as a business expense. Nor can it be used to reduce the amount of the capital gain which will ultimately arise when the property is disposed of. Nevertheless, a professional appraisal can be most worthwhile and it is probably the strongest ammunition you can have in defending your V-day value if it should be disputed by Revenue Canada.

If you decide to carry out your own valuation you may have a major job on your hands but there is no reason why you cannot do it. After all, your knowledge of the farm assets is probably more detailed than anyone else's. Setting up a good file on V-day documentation to support the values for various farm assets is a major topic for discussion itself.

We recommend that you obtain a copy of a helpful instruction guide on farm valuation published by the British Columbia Ministry of Agriculture and Fisheries called "Valuation of British Columbia Farm Assets for Capital Gains Tax". This publication will be useful in a do-it-yourself appraisal and in assembling information for a professional valuator.

A final note on valuation of farm property

A natural question for a person to ask is, how are the tax authorities going to know what my farm was worth at V-day? Revenue Canada maintains a staff of people who are expert in the field of appraisals and business valuation.

They can compile detailed information on comparable real estate transactions which took place close to V-day. This information will be available to assist a tax auditor in determining whether or not your V-day value is reasonable.

If you do not do a proper V-day valuation and support it with appropriate documentation, or have one done by an appraiser, you may be forced to accept Revenue Canada's value which may not be as accurate or as advantageous as the one which you could obtain.

We are many years away from valuation day already. Don't let another year go by without looking into tha important task of determining the value of your farm as of December 31, 1971.

Additional record keeping if you are a partner in a partnership

If you are a partner in a partnership you need to understand that for income tax purposes the partnership is treated as being an entity that is separate from you and your other partners. In some respects it is similar to a corporation which is separate and distinct from its shareholders.

Because of this separate entity concept you, as a partner, can realize capital gains in one of two ways. The first is to arrange for your partnership to sell one or more of its capital assets. Because of the special flow-through rules that apply in partnership situations, a portion of the partnership's capital gains will be allocated to you and will be included in your income.

The second way in which you might realize a capital gain is to sell your interest in the partnership. In effect you would be selling your interest in all of the partnership's assets rather than having your partnership sell the individual assets. This type of transaction will not usually occur in an arm's length sale - but it can occur where the farm is being passed from you to your children.

The point we want to make here, is that at some point you will cease to be a partner of your partnership and at that time you will be required to calculate whether you made a gain or a loss when you disposed of your partnership interest. In order to calculate this gain or loss, you have to know the "tax cost" of your partnership interest. Unfortunately, the calculation of this "tax cost" can be complicated, particularly where you were carrying on your partnership business before 1972. You have to know what your v-day values were ***and you have to keep track of certain information after 1971 such as your income for tax purposes and your drawings from the partnership.***

If you haven't been keeping track of the "tax cost" of your partnership interest on a year by year basis, talk to your accountant about doing this from now onwards. The further we move away from 1971, the more difficult it will be to get at the tax returns for those earlier years. It is far better for you to maintain this calculation on an ongoing basis than to scramble around trying to estimate it when you really need it.

Chapter 5

WHAT YOU SHOULD KNOW ABOUT INCOME AVERAGING

For many years there have been averaging rules in the Income Tax Act to provide relief to individuals if their incomes increase unduly over the average for the previous few years. Prior to 1988 there were two sets of rules - one applying to full-time farmers and the other applying to all individuals. Now we have only the farm rules and even these will be eliminated after 1993.

The government's reasoning for phasing out these rules is that as a result of the 1987 Tax Reform there are only 3 tax rate brackets and the difference between the low and high rates for a resident of B.C. is only 20%. Under the pre-Reform system, there were approximately 10 brackets and the difference between the low and high rates was approximately 40% for a resident of B.C. The government concluded that under the new system there wasn't the same need for income averaging and even if the rules were maintained, they wouldn't have provided much relief because of the reduction in the number of brackets and the range in the rates.

Because the averaging rules applying to all individuals (called forward averaging) were to all intents and purposes eliminated in 1988, we will not comment on them any further in this publication. Instead we will only describe the rules applying to farmers - which are known as the "block averaging" provisions.

Who can use block averaging?

It can be used by all individuals whose chief source of income was farming throughout the five-year block-averaging period. The "Farming Income Tax Guide" gives an excellent summary and illustration of five-year block averaging. Keep in mind that the chief source of a person's income is a question of fact, based on individual circumstances, and will be determined separately for each year in the averaging period.

Also remember that as a result of Tax Reform, the first year in the averaging period must end before 1988 and be one of the six years before the year of averaging. Expressed another way, you can elect to block average only once after 1986 and the absolute latest year in which an election can be filed is 1993. If you report income in each of the years subsequent to 1986, the last year in which you will be able to block average will be 1991. It is only where you have no income to report in two of the years subsequent to 1986, and don't want to include those years in the averaging period, that the final year for making a block averaging election is extended to 1993.

What does a person have to do to take advantage of block averaging?

Nothing has to be done until you file your income tax return in the year of averaging. But you must have filed your returns on time for the other four years in the averaging period and your chief source of income for each of the five years must have been farming. Form T2011 must be completed and filed with your return. Note that a nil income year can still be included in the averaging period if the return for that year is sent in at the same time as the tax return for the year the block averaging calculation is utilized.

It is important to note that a block averaging election cannot be made in a year if forward averaging has been used in that year or in any other year in the averaging period.

It is also important to be aware that the alternative minimum tax rules will not apply in any year in which a block averaging election is made.

Chapter 6

THE TAX TREATMENT OF BASIC HERDS AND OTHER FARMING INVENTORIES

In Chapter 3, we talked about the adjustment to the cash basis of accounting that you are required to make in respect of your livestock and other inventories - where you incur a loss. We also discussed the optional inventory adjustment that you can make in order to average your income between years or to fix it at a pre-determined level in a particular year.

In this chapter we will discuss briefly how our federal income tax law deals with basic herds and with livestock and crop inventories of farmers who choose the accrual basis of accounting.

A. Livestock inventories

We will deal with these assets under three separate headings: basic herds, the constant unit value election and non-basic herd livestock. As time goes on, and our tax system matures, tax problems involving basic herds will gradually disappear and questions regarding the other methods of accounting for livestock will replace them. However, basic herds will be around for some time yet so it is important to understand the rules.

Basic herds

These were part of the tax system before 1972 and applied to certain specified groups of animals (cattle, horses, sheep or swine) owned by a farmer. Once a basic herd of a class of animals was established for income tax purposes the cost of additions to the basic herd was not deductible and the proceeds from reductions of the basic herd were not taxable. In other words, the herd was recognized as a capital asset of the farmer or rancher in somewhat the same way that plant and equipment are capital assets to a manufacturing business. It is interesting to note that the basic herd concept was not authorized by law under the pre-1972 tax system but was strictly the result of the practice of the tax authorities. In the law now, however, basic herds are defined but they are also being done away with! No new basic herds can be established now nor can existing ones be increased. Special transitional rules have been allowed to carry over into the new tax system.

Simply stated, the transitional rules provide two different ways in which this phasing-out of existing basic herds will be accomplished; the mandatory reduction and the optional reduction.

The mandatory reduction

As a general rule, if the number of animals in the herd at the end of a taxation year is less than the approved basic herd number, your approved basic herd must be reduced to the lower figure. You must then take a deduction from your income representing the amount of the reduction which has occurred in your herd. The formula would be:

Deduction from income for basic herd reduction	=	number of animals by which herd was reduced	x	average of the fair market value of all the animals in that class at December 31, 1971

If you have a basic herd and want to ensure that you are not affected by this mandatory reduction in the basic herd you should ensure that, at the end of the year, the number of animals in that class is not less than the number of animals in your approved basic herd

for that class of animal. If this is done each year the basic herd can be continued indefinitely.

Optional reduction

If you do not have a decrease in your herd which brings the mandatory reduction into effect, you still have the choice of using the optional reduction. These rules allow a farmer to write off each year for tax purposes a maximum of one-tenth of the December 31, 1971 fair market value of his basic herd. In fact, though, the amount of the allowable deduction may be less than that since it cannot exceed the least of three amounts

1. the number of animals of the class disposed of in the year;
2. 10% of the basic herd at December 31, 1971; and
3. the number of animals in the basic herd at the end of the preceding year.

You should note that where a write-off of 10% of the basic herd is available, it does not have to be taken in full. Any amount less than 10% could be taken for the year. The same principle applies here as applies to cash basis farmers with livestock inventories which do not qualify as basic herds (see Chapter 3). You might need to take only a 5% write-off, for example, to reduce your taxable income to nil. Or in a year of relatively low income you might prefer not to take any write-off and save the deduction until future years when profits are higher.

These are the tax principles which apply in the phasing-out of basic herds. Several years ago, Revenue Canada issued an excellent summary of the basic herd rules, together with illustrative examples. This booklet is entitled "Basic Herds" and can be obtained on request from your District Taxation Office. Every farmer who accounts for any of his livestock on this basis should have a copy of this publication to guide him as to the tax treatment of his purchases and sales.

V-Day values

If you have not yet established the December 31, 1971 market value for your basic herd then it would be wise to do so as soon as possible. As in the case of other V-Day valuations, the higher the value assigned to the animals the greater the advantage when the animals are disposed of. But the values must be reasonable to be accepted by the tax authorities.

What happens to the herd if a farmer dies or goes out of business?

Suppose that at the time of a farmer's death his livestock herd has a fair market value of $150,000 and the dollar amount of his basic herd at December 31, 1971 which had not yet been written off for tax purposes was $80,000. In the final income tax return of the farmer the $150,000 must be shown as income (unless the herd passes to your heirs within a certain time limit - see below) but this will be partially offset by the deduction of the $80,000.

Legal representatives who look after the deceased farmer's affairs should be aware that a separate tax return can be filed to report a cash basis herd and a second set of personal exemptions can be claimed on this return.

As an alternative, the legal representative may, within certain time limits, transfer the ownership of the herd to the widow or children who are the beneficiaries of the estate. If this is done, the value of the herd is taxable in the hands of the beneficiary who inherits the livestock, but not until the herd is sold in the ordinary course of events.

If the deceased farmer has a basic herd which has not been written off for tax purposes, the legal representatives should ensure that a sufficient portion of the herd's value is included in income in the year of death so as to absorb the deduction for the basic herd. Care must be taken in the manner in which this is done. A beneficiary who inherits basic herd animals will not be permitted to carry on with the basic herd concept.

When a farmer goes out of business and sells his herd, he will be able to deduct the 1971 value of his basic herd which has not yet been written off for tax purposes and the full amount of proceeds from the sale will be brought into income as it is received.

Miscellaneous comments on basic herds

There are some additional points that we would like to make regarding basic herds. The first point, already mentioned but worth repeating, is that even though the basic herd is treated like a capital asset, increases in the value of the animals are not treated as capital gains (three-quarters taxable) but as ordinary income (fully taxable). Secondly, basic herds were available under the pre-1972 tax system not only to cash basis farmers but also to farmers who used the accrual method of accounting. This practice is continued under the present rules and Revenue Canada's booklet shows how the calculations would be made. Farming corporations, provided they had established their basic herds by the date their 1971 income tax returns had to be filed, are also entitled to use the basic herd rules in the same manner as individual farmers.

The constant unit value election for farmers who are not on the cash basis

Under the present tax system, farmers are entitled to use the accrual method of accounting, under which inventory values must be taken into account, or the cash method under which inventory values can generally be ignored. Most farmers are probably using the cash method because of its advantages (see Chapter 3), but there may be some farmers who, for various reasons, choose to use the accrual method of accounting. In a period when the value of livestock is rising it is possible that profits calculated on this basis may be high purely as a result of the value of a farmer's inventory. It is conceivable that a farmer could show a profit on which he has to pay tax but have no cash with which to pay such taxes since his profit for the year is largely represented by an unrealized increase in the value of inventory. In recognition of this type of problem, the government has provided a special election for farmers who report income on the accrual basis. This election enables them to report their inventory at values which remain level from one year to the next. The result is that the ups and downs of the livestock values in inventory are removed and your profit can be closer to your cash intake for the year.

The election is available to any person in the business of breeding and raising animals but may not be used with respect to registered animals, feedlot operations or animals bought for resale. The election is made by filing special form T2034 with your income tax return for the year in which the constant unit value is adopted.

Non-basic herd livestock inventories

For farmers on the accrual basis, the inventory of livestock is accounted for using the same principles which apply to the inventory of any other type of business. An exception to this rule is the constant unit value election which we mentioned above.

As mentioned in Chapter 3, those farmers on the cash basis of accounting can deduct payments made in respect of livestock purchases and must include all payments received in respect of livestock sales. Where this results in a cash-basis loss, farmers may be required to make an adjustment in respect of their year-end purchased inventories (see Chapter 3).

B. Crops and other inventories

As with livestock, inventories of crops or other items can be ignored by cash method farmers (assuming they do not have a cash-basis loss - see Chapter 3) but must be accounted for by accrual method farmers. These inventory items could include such things as hay, grain, feed pellets, seed, fertilizer, fencing wire and posts, and other supplies of any kind. The methods of accounting for inventory which are acceptable under the income tax rules are spelled out in the "Farming Income Tax Guide".

The principles and options discussed above which apply to your livestock inventory when you die or go out of business also apply to your crop and other inventories.

We should remind British Columbia grain farmers of the possible use of the deferred cash purchase ticket as a means by which crop inventories can be sold but proceeds are not taxable until the subsequent year. Grain delivered to either a primary or process elevator may qualify. The use of these tickets is described in the "Farming Income Tax Guide":

> *"When you deliver grain to a licensed public elevator or process elevator, you may receive a storage ticket, a cash purchase ticket or a deferred cash purchase ticket. If you are given a storage ticket, no sale has taken place. Therefore, you are not considered to have received income at that time. If you are given a cash purchase ticket, a sale has taken place. You are considered to have received payment at that time, regardless of when you present the ticket for payment. If you are given a deferred cash purchase ticket, you may be eligible to report the purchase price stated on the ticket as income in the next fiscal period if the ticket provides for payment after the end of the fiscal period in which you delivered the grain for sale. This deferral of income is only available in certain circumstances. For details of these circumstances, obtain Interpretation Bulletin IT-184R, "Deferred Cash Purchase Tickets Issued for Grain".*

The use of a deferred cash purchase ticket might enable a grain farmer to sell his grain, thus taking advantage of the price prevailing at a particular point in time, while deferring the income for tax purposes until a subsequent tax year.

Chapter 7

DEPRECIABLE ASSETS USED IN THE BUSINESS OF FARMING

Most persons in the farming business are aware that the cost of assets of a long-lasting nature, such as machinery, equipment, vehicles and buildings, cannot be deducted for tax purposes as an expense. Instead, the expenditures are considered to be of a capital nature and the cost must be deducted from income over a period of years by claiming a special deduction based on the cost of the assets. The methods by which this deduction (the tax term is "capital cost allowance") must be calculated are set out in the regulations to the Income Tax Act.

Under the pre-1972 income tax system, you could choose between two different methods of calculating capital cost allowance:

A. the straight-line (Part XVII) method, and

B. the declining balance (Part XI) method

Under the present law the straight-line method is being phased out. No asset purchases after December 31, 1971 can be written off on this basis. However, assets which were owned at December 31, 1971, provided they have never been written off on the declining balance basis, may be depreciated on the straight-line basis as long as you remain in the business of farming. You may, of course, at any time transfer the undepreciated cost of a straight-line asset into a prescribed asset class under the declining balance basis. But once this decision is made it is irreversible. As in the elimination of basic herds, the phasing out of straight-line capital cost allowance will be a gradual process that will probably take a number of years to accomplish.

The mechanical rules for the two methods are familiar to most farmers so it is not necessary to repeat them in detail here. (Those who would like additional information on the Part XI system can obtain it from the "Farming Income Tax Guide". Additional information on the Part XVII system can be obtained from Information Circular 86-5R, Part XVII Capital Cost Allowance, Farming and Fishing.) It is appropriate, however, to provide a summary of some of the major similarities and differences. This listing may assist you to decide whether or not you should continue on the straight-line basis or switch over to the declining balance method.

A. There is flexibility as to the amount of annual deductions under both methods.

B. There are higher write-offs in the initial years under the declining method.

C. Generally, there is no capital cost allowance in the year of sale on a declining balance asset but a pro-rated amount on a straight-line asset.

D. There is no recapture or terminal loss on the sale of straight-line assets.

E. Capital gains may arise under both methods but capital losses do not arise under either.

F. There is no tax when depreciable assets are transferred to a spouse or left to a spouse under a will.

G. Declining balance assets may be transferred to a child at their tax value whereas straight-line assets can be transferred only at their fair market value.

As a general rule, it will usually be preferable for you to stay with the straight-line method wherever you can and to use the declining balance method for only those assets which you acquired after 1971. If you decide to take the simpler approach and switch all of your

assets to the declining balance basis, Information Circular IC 86-5R referred to above has an outline of the procedures to follow in making the change in your tax return.

Recapture of capital cost allowance/terminal losses

Under the declining balance system, expenditures for depreciable properties are added to the appropriate capital cost allowance class and depreciation is claimed on the balance in that class at the end of your fiscal period. If you dispose of any property, the sale proceeds (up to the property's original cost) are deducted from the undepreciated balance in the appropriate class and you depreciate the net amount. If the proceeds exceed the undepreciated balance in the class (after taking into account the additions to that class in the year of sale) the excess is generally included in your income as recaptured depreciation.

If you dispose of property depreciated under the straight-line system and the proceeds exceed the depreciated value of the asset, the depreciation claimed in previous years is not recaptured. Of course, if the proceeds exceed the higher of the original cost or the value at the end of 1971, the excess will be treated as a capital gain and three-quarters (two-thirds in 1989) will be subject to tax. (The precise date on which the fraction increased to three-quarters depends on whether the taxpayer is an individual or a corporation and, if it is a corporation, whether it is Canadian-controlled. See page 21 for further details.)

If you dispose of all property in a declining balance class and there is an undepreciated balance in that class, the ending balance is generally treated as a terminal loss that can be written off against any type of income.

If you transfer Part XI depreciable property to a partnership or to a corporation that you control (as defined), there are provisions in the Income Tax Act which prevent you from deducting the terminal loss that would otherwise arise. These provisions apply to individuals, partnerships and corporations. There are also rules that will restrict the deduction of a terminal loss arising on the sale of a building in situations where the land on which the building is situated is sold at a profit. These rules require taxpayers to net the terminal loss against the capital gain arising on the land.

Government incentive through special capital cost allowance rates for certain assets

Sometimes, as a means of encouraging a certain type of economic activity, the federal government increases the write-offs available on certain kinds of assets. These special write-offs normally have a limited life and their availability usually depends on the particular time period in which the asset was purchased. The incentives are available only for declining balance assets.

Two examples of increased write-offs which are of particular interest to certain British Columbia farmers are the rates applying to buildings used for storing fresh fruit and vegetables, and buildings used for preserving ensilage. Buildings acquired after February 19, 1973 that are used for these purposes will be eligible for a write-off rate of 20% per annum instead of the regular 5%.

Certain depreciable assets acquired primarily for the purpose of pollution control, and equipment that generates electrical energy from wind will qualify for rapid write-off. Information is available in the "Farming Income Tax Guide".

Effect of the investment tax credit on the capital cost of depreciable assets

If a farm business acquires a depreciable asset that qualifies for the investment tax credit (see details in Chapter 8) then, at the time the credit is utilized, the amount of the credit must be deducted from the capital cost of the property.

Government Grants

Government grants or loan forgiveness may be income or capital in nature. If income, the grant will increase the net income or reduce the net loss. A capital grant will generally reduce the capital cost upon which capital cost allowance is claimed. Further information is available in Revenue Canada's Interpretation Bulletins IT-273R and 276.

Lease-Purchase Arrangements

If you acquire a property previously leased after December 11, 1979, and later sell it, the Income Tax Act contains a provision under which the recapture of lease payments is possible. In other words, amounts deducted in prior years could be brought back into income.

Change of control of a corporation - effect on undepreciated capital cost of Part XI property

If control of a farm corporation changes, the undepreciated capital cost (U.C.C.) of Part XI depreciable property owned by the corporation is reduced to its fair market value. This reduction is done on a class by class basis. The amount deducted from the U.C.C. is added to the corporation's non-capital loss carry-forward.

Reduced capital cost allowance in the year of purchase

Capital cost allowances that may be claimed in the year of purchase on Part XI property is generally restricted to one-half of the amount that would otherwise be available. This restriction applies to most property acquired after November 12, 1981. Accordingly, if you construct a farm building in your 1989 taxation year at a cost of $25,000 that ordinarily could be depreciated at the rate of 10%, the maximum capital cost allowance that may be claimed on this building in 1989 will be 1/2 x 10% x $25,000 = $1,250.

Interest during construction

As a result of rules put into the Income Tax Act in 1981, interest incurred after 1981 on amounts borrowed to construct or renovate farm buildings must be added to the cost of the building for the period during which the construction or renovation was carried on. These rules also apply to other costs incurred during the construction period that relate to the building project.

Capital cost allowance changes in the 1987 Tax Reform

As part of its drive to expand the tax base the government has reduced the capital cost allowance rates on certain types of property acquired after 1987. In some cases the reduction is being phased in over several years. Most of the changes that could impact on farmers are explained in the "Farming Income Tax Guide".

Capital cost allowance on automobiles

As part of the 1987 Tax Reform, the rules dealing with the deductibility of automobile-related costs were changed. One of the changes was to restrict to a prescribed amount (currently $24,000 - $20,000 for vehicles acquired before September 1989) the maximum cost that can be depreciated for tax purposes in respect of an automobile acquired after June 17, 1987. This limitation applies in fiscal periods and taxation years commencing after June 17, 1987 that end after 1987. ***It is interesting to note that pick-up trucks with only one bench seat which are used primarily for the transportation of goods in connection with a business are not treated as automobiles and are not subject to this limitation.***

Under the new system automobiles costing more than $24,000 ($20,000 for vehicles acquired before September 1, 1989) that are acquired after Tax Reform are depreciated in a new capital cost allowance class (10.1). Each vehicle is treated as being a separate class within 10.1. As a result of a Department of Finance release dated January 1989 - it is now clear that pre-Reform vehicles do not have to be transferred to the new class at the end of your 1988 fiscal period (contrary to the information in the 1988 Farming Income Tax Guide). Instead, these vehicles remain in Class 10 and are depreciated in accordance with the normal rules.

Unlike other capital cost allowance classes, there is no recaptured depreciation or terminal losses on the sale of vehicles in the new class 10.1. If a Class 10.1 vehicle that was on hand at the end of the previous year is sold in a particular year and is replaced by a new class 10.1 vehicle that is still on hand at the end of the year, the farmer is able to claim on the old vehicle one-half of the capital cost allowance that would have been available had it not been sold in the year.

Chapter 8

THE INVESTMENT TAX CREDIT: A FORMER TAX INCENTIVE FOR CAPITAL EXPANSION

This tax incentive was introduced in the mid 1970's to stimulate investment in buildings, machinery and equipment by certain Canadian businesses. In the subsequent years, the government "tinkered" with the rules almost constantly - gradually extending and amplifying the incentive. Then in 1986, the government announced that the system was to be phased out in most cases, with the phase-out scheduled to begin on January 1, 1987.

Because the vast majority of credits no longer apply to expenditures incurred after 1988, we have restricted our commentary to matters affecting the utilization of credits earned in previous years.

What is the investment tax credit?

The investment tax credit is a credit against federal tax that is based on the capital cost of certain types of property acquired within certain time limits. A taxpayer, whether an individual, a member of a partnership or a corporation, may claim the investment tax credit to reduce the amount of federal income tax that is otherwise payable. British Columbia income taxes are not reduced by the investment tax credit.

What are the effective dates?

The investment tax credit applied to acquisitions of prescribed buildings or prescribed machinery and equipment acquired after June 23, 1975. Certain expenditures for scientific research made after March 31, 1977 and acquisitions of certain transportation equipment after November 16, 1978, also qualified for the credit. Generally speaking, expenditures incurred by farmers after 1988 will no longer qualify for the credit.

If the amount of the credit available is not used in the year that it arises, can it be carried forward or backwards?

Yes. The investment tax credit in respect of expenditures after April 19, 1983 may be carried forward for up to ten years and back for up to three years. The credit for expenditures made prior to April 20, 1983 may be carried forward for only five years and there is no carryback.

Is there discretion available to the taxpayer as to how much of the credit he claims each year?

Generally, the same discretion principle that applies for claiming capital cost allowance applies to the investment tax credit as well. You have the choice of claiming any amount up to the maximum allowed each year.

Commencing with the 1988 taxation year, the maximum is calculated by what is referred to as the investment tax credit limit. In the case of a corporation, this limit is defined as being all of its federal tax under Part I of the Act on the income eligible for the small business deduction plus 3/4 of the remainder of its federal tax payable under that Part. In the case of an individual, the limit is $24,000 plus 3/4 of the amount by which the individual's federal tax liability under Part I of the Act exceeds $24,000.

Does a recapture of the investment tax credit occur when an asset is sold?

No. Even though a depreciable asset is sold shortly after the investment tax credit claim has been made, no recapture of the tax credit per se will occur.

Investment tax credits deducted by members of a partnership

Investment tax credits earned by a partnership must be allocated to the partners. Amounts deducted by the partners from their federal income taxes payable will reduce the adjusted cost base of the partners' interests in the partnership.

Change of control of a corporation

Where there is a change of control of a corporation after January 15, 1987, there are complicated rules which are intended to restrict the carry forward or carry back of unused investment tax credits if there is a change in the nature of the business carried on by the corporation.

Summary

The investment tax credit has been an important part of our Canadian income tax system. Most of the credits have now been phased out, but because of the length of the carry-forward period, you may be in a position to benefit from your accumulated credits for a number of years.

Chapter 9

GOVERNMENT RIGHTS AND LICENSES

The government has recognized that under our present tax system there are many kinds of business expenditures which cannot be deducted as expenses of the current year and also cannot be depreciated over a longer period of time under the capital cost allowance system. Under the pre-1972 tax regime such amounts were appropriately called "nothings" since no tax relief was available. To help alleviate this inequity a new set of write-off rules called the eligible capital expenditure rules were introduced in 1972.

As the name "eligible capital expenditure" suggests, expenditures after 1971 on so-called "nothings" were in some respects treated similarly to capital properties. However, the properties themselves (referred to as eligible capital properties) were not capital properties and were therefore not eligible for the capital gains deduction.

Then, in April 1988, as part of the 1987 Tax Reform, the government announced that a portion of the gains realized on the sale of "eligible capital properties" will now be eligible for the capital gains deduction. This will apply to individual farmers only (and to most individual farmers who carry on business in partnership) in respect of the sale of eligible capital properties in fiscal periods commencing after 1987. For a farmer with a calendar year-end, this will apply to sales from January 1, 1988 onwards.

For some sectors of the agricultural industry this was one of the most important tax changes in recent years. In the dairy sector for instance the value of milk quota (which is an eligible capital property) accounts for much of the accrued gain on the typical dairy farm. This asset can now be sold by a retiring farmer at a significantly reduced tax cost - perhaps even no cost at all. Now that quota gains are eligible for the capital gains deduction, quotas are in many respects treated similarly to capital properties such as buildings and equipment.

In the agricultural industry, milk, poultry and other quotas are the most common examples of property which qualify for the eligible capital property rules - so we will concentrate on them in this chapter. Other expenditures which also qualify are as follows:

- payments for goodwill on the purchase of a business
- incorporation costs
- certain franchises

In this chapter, we will consider what happens when:

A. quota is acquired after V-day
B. quota is sold after V-day
C. an individual dies and owns a quota at the time of his death
D. an individual transfers quota to a child by sale or gift

We will also look at the minimum tax implications and the position of the farmer who carries on business in a company.

A. Quota is acquired after V-day

If you have acquired quota after V-day, you will have an asset which can be written off for tax purposes in a manner which is quite similar to rules followed under the capital cost allowance system (Chapter 7). These basic guidelines should be kept in mind:

1. To be eligible for a deduction the asset must have been acquired after 1971. No assets owned at V-day can be written off in this manner.

2. The asset must have been acquired for the purpose of earning income from a business carried on by you.

3. Three-quarters of the expenditure is put into a special tax account called the cumulative eligible capital account (CEC) which can be written off at the rate of 7% per annum on a declining balance basis. (Before the 1987 Tax Reform only 50% of expenditures were eligible for write-off and were depreciated at the rate of 10% per annum. The new rules came into effect for taxation years commencing after June 1988, in the case of corporations, and for fiscal periods commencing after 1987 for other taxpayers.)

4. Because the percentage of quota sale proceeds that is taken into account for tax purposes was increased from 50% to 75% (see below), the balance in the CEC pool (the balance of depreciated expenditures) was increased by 50%. This increase was made at the beginning of the first accounting period in which the new write-off rules apply.

B. Quota is sold after V-day

The rules applying to the sale of quotas and other government rights are essentially as follows:

1. Three-quarters of the sales proceeds applicable to post-71 quota purchases are credited to the CEC pool. (Before the 1987 Tax Reform only 50% of sale proceeds were taken into account. This change was effective in the taxation year and fiscal periods described above.)

2. Three-quarters of the excess of the sale proceeds of pre-1972 quota over the market value of that quota at the end of 1971 (or original cost, if higher) are credited to the CEC pool. Again, the fraction was 50% prior to the 1987 Tax Reform.

3. If the amounts credited to the CEC pool exceed the depreciated expenditures at the beginning of the year of sale, the excess is treated as follows:

   a) Corporation
      - the amount is considered to be ordinary business income

   b) Individuals
      - an amount equal to the quota write-offs from 1972 onwards (net of quota income inclusions) is treated as ordinary business income
      - the balance is treated as a taxable capital gain

These rules can be illustrated as follows:

Assume:
Farm has a calendar year-end
1,000 lbs. of quota held on V-day (1971 value - $38,000)
2,000 lbs. acquired after V-day at a cost of $200,000
Write-offs to December 31, 1987 - $30,000
Sale in 1988 - $800,000

CEC Pool		$ 100,000
1/2 expenditures		(30,000)
less write-offs to December 31, 1987		
		70,000
Add 50% adjustment as a result of Tax Reform		35,000
		105,000
Proceeds	800,000	
Less V-day value	38,000	
	762,000	
3/4 thereof		(571,500)
Total gain		$ (466,500)

If taxpayer is an individual, the "total gain" is treated as follows:

Business income		$ 30,000
Taxable capital gain		436,500
		$ 466,500 (Note)

Note: Maximum capital gains deduction in 1988 was $333,333 (2/3 x $500,000)

C. An individual dies and owns a quota at the time of his death

In Chapter 14 we discuss the general rule that a person's property is deemed to be disposed of at the time of his death. ***The rules applying to quota are such that no tax will arise from the disposition and the person inheriting the asset will be put in the same tax position as the deceased, provided the same business is carried on.*** Under a separate rule, this rollover treatment also applies when the asset is left to a spouse and that person carries on the same business.

D. An individual transfers quota to a child by sale or gift

A transfer of an agricultural quota to a child (see chapter 15 for a definition of "child") of the farmer will qualify for the same kind of "rollover" treatment that is given to land and depreciable assets used in a farming business. Such a transfer could be by way of gift or sale. If the quota is sold to the child and three-quarters of the sale proceeds exceeds the balance of the depreciable portion of the expenditures which have not yet been written off, the excess will be treated as business income or a taxable capital gain.

It is important to note that where you sell quota to a non-arm's length person such as a child, or a corporation that you control, the cost of the quota to that person is reduced by four-thirds of the amount of the capital gains deduction claimed by you.

E. Minimum tax implications

As mentioned in Chapter 13 a taxable capital gain arising on the sale of quota will not bring the minimum tax rules into play. This makes the 1988 tax change even more valuable.

F. What is the position of the incorporated farmer?

Not as good as the individual farmer. As a result of Tax Reform, the company's income inclusion from the sale of its quota will be 50% higher than it used to be. This could result in a substantially increased tax liability - particularly on a dairy farm.

If an incorporated farmer wants to sell his farm, he should try to sell the shares of his company rather than having the company sell its assets. Depending on the circumstances, a sale of shares may enable the farmer to take advantage of the $500,000 capital gains deduction.

G. Conclusion

This tax change is an important tax concession to those individual farmers who are required to hold quotas in connection with their businesses. ***Because their future tax liability will be affected by quota write-offs (or income inclusions) since 1971, they should summarize this information before it gets lost.***

Chapter 10

WHAT YOU SHOULD KNOW ABOUT THE TAX TREATMENT OF YOUR FAMILY HOME

Most taxpayers are aware that, as a general rule, three-quarters of the amount of a person's total capital gains, less any capital losses, is included in income for tax purposes (two-thirds in 1989). ***Any gain that an individual realizes when he sells his house, however, is still tax-free.***

We would caution British Columbia farmers that the above rule might not always apply to their homes. The rules relating to this topic can become quite complex. Revenue Canada has issued Interpretation Bulletin #IT-120R3 on the subject which is required reading for everyone who owns a home. To provide some general guidance on this topic, we will attempt to answer a few basic questions that are relevant to British Columbia farmers.

These are:

A. What is a principal residence for income tax purposes?

B. What is the special alternative which exists for farmers only?

C. Can a husband and wife each have a property that is a principal residence?

D. What happens if you are a farmer claiming part of the farm home expenses as a deduction from your farm income each year?

E. What happens if a family home is left in trust to a spouse?

A. What is a principal residence for income tax purposes?

Four different elements must be fulfilled before your home will qualify as a principal residence on which the capital gain will be tax-free. These elements are as follows:

1. Housing unit

The property must be a housing unit. This includes any land on which the housing unit stands that contributes to the use and enjoyment of the housing unit (up to an acre (or 1/2 hectare in the new metric language) is accepted without dispute).

2. Ownership

The property must be owned by you either by yourself or jointly with another person.

3. Ordinarily inhabited

The property must be ordinarily inhabited by you during, not necessarily throughout, each year that it is claimed as a principal residence. Seasonal residences may qualify.

4. Designation of the property as a principal residence

Form T2091 should be filed with your tax return for the year that you dispose of a principal residence; however, if none of the gain will be taxable anyway then the tax authorities will not insist that this form be filed. Remember that each

individual can designate only one property as a principal residence for any particular calendar year.

Those are the four basic requirements of a principal residence. If your property qualifies as a principal residence throughout the period you own it, the capital gain will generally be tax-free.

B. What is the special alternative which exists only for farmers?

The Income Tax Act allows you two methods in which to calculate your exempt gain when you dispose of your farm property. The first one requires a hypothetical division of the farm into two portions. One part will be the farm house plus one or more acres which contribute to its use and enjoyment. The other part will be the rest of the farm property. A reasonable allocation of the sale proceeds must then be made between the two parts. The same allocation must be made for the adjusted cost base (in most cases the December 31, 1971 value of the farm or original cost if it was bought after that date, plus improvements). Once this is done then the capital gain on the principal residence portion and the capital gain on the rest of the farm can be calculated. The principal residence gain will be exempt from tax. The gain on the rest of the farm land will be treated in the same manner as any other capital gain which is subject to tax.

The second method is somewhat simpler to calculate because there is no need to segregate the principal residence portion of the property from the rest of the farm. Instead, you will take the proceeds of disposition of the whole farm, less selling expenses, and subtract your adjusted cost base to arrive at your capital gain. You can then reduce this capital gain by an amount equal to $1,000 plus $1,000 for every year that the house has been your principal residence. Part years count as full years for this purpose. If you owned your farm from November, 1975 to January, 1989, for example, your exemption would be $1,000 plus 15 x $1,000 = $16,000. To take advantage of this second method you must file a special letter with your tax return which sets out certain information concerning the property.

The circumstances of each case will determine which method will be the better one to use. You should at least be aware that both methods exist and that you are entitled to use the one which gives you the larger exemption. During a period of declining real estate values, the second method could produce a special tax benefit which would be available only to farmers.

C. Can a husband and wife each have a property which is a principal residence?

This used to be possible but the income tax law was amended to provide that commencing in 1982, a family may treat only one residence as its principal residence for a taxation year. So, if you and your spouse each own a property which qualifies as a principal residence, the capital gains that accrued to the end of 1981 on both properties will be exempt from tax. The capital gains that accrued after 1981, however, can be exempted on only one property. The complete exemption on two properties that applies in respect of capital gains accrued to the end of 1981 will apply only if each of you owns one of the properties outright.

D. What if you claim farm home expenses each year?

Where a home located on a farm is used to earn farm income, the income tax authorities have traditionally allowed a farmer to claim as a business expense a certain portion of costs incurred in connection with the home. As a matter of administrative practice the deduction has been limited to 1/4 of repairs to the home and a reasonable portion of the cost of light, power, heat, taxes, telephone and fire insurance. If a home is located off the farm then in the past, no deduction for expenses was generally allowed unless a specific

part of the home was used exclusively in the course of the farming business. If a house on the farm is used solely for the purpose of providing lodging to hired help, then the full amount of expenses paid by the farmer in connection with the house is allowed as a deduction.

These rules have been tightened somewhat as a result of the 1987 Tax Reform. ***In fiscal periods commencing after 1987, expenses relating to a work area in a farmer's residence will be deductible by an individual only to the extent that it is his principal place of business and only to the extent that he has income from that business.*** While it is not entirely clear, it appears that if the residence is located on the main farm it will be treated as his principal place of business. Expenses relating to the work area will then be deductible if the farmer reports income from the farm. If there is a loss, the work area expenses may not be used to increase the loss but are available for carry-forward to a future year. If the residence is not located on the farm it will not be your principal place of business and expenses will not be deductible.

Capital cost allowance may also be claimed on the farm home. The government's administrative practice regarding the deduction of expenses also applies to the claiming of capital cost allowance. The depreciation schedule (Form T2041), which a farmer fills out each year when he files his tax return, shows how the claim is made for assets depreciated on the straight-line method. The claim is made in a similar way for assets depreciated on the declining balance basis. The portion of the cost of the home, excluding the land, of course, which represents the part of the home used for farm business purposes would have to be calculated. Capital cost allowance would then be taken on this amount in the same manner as on any other farm building.

It is important to bear in mind, that when you dispose of your farm home, the fact that you have taken a deduction for capital cost allowance over the years may result in some additional income tax if recapture occurs.

Three quarters (two-thirds in 1989) of the capital gain on the portion of the home that is depreciated for tax purposes will be subject to income tax when the home is sold (subject to the availability of the capital gains deduction). If capital cost allowance is not claimed this portion of the capital gain may still be tax-free.

E. <u>What happens to the principal residence exemption if a farm home is left in trust to a spouse when a farmer dies?</u>

We mention this point because it is not uncommon for a family home to be left in trust to a spouse for the balance of her lifetime and then to the children when the spouse dies. No capital gain arises at the time the property passes to a trust created for the spouse, providing the trust meets certain conditions set out in the <u>Income Tax Act</u>. Even if a gain did arise at this time it would normally be fully exempt from tax because it would be a gain from the disposition of a principal residence.

What we are concerned with here is a situation where a home owned by a trust is occupied by your widow for a period of years and increases in value until either it is sold or the widow dies. One of our principal residence tests, ownership, is missing since the trust, not the widow, owns the property. In this case, the <u>Income Tax Act</u> provides a special rule which allows the trust to designate the property as a principal residence. The entire capital gain arising since December 31, 1971 may be exempted from tax providing the proper designation is made.

Assume a farmer owned his home from 1972 to his death in 1980, during which time it increased in value by $25,000. The home went into a spouse trust for his widow who lived in the home until her death in 1989, during which an additional increase in value of $30,000 occurred. The income tax rules are designed in such a way that both of these

increases in value will be tax exempt. It is important, however, that the appropriate designation of the property as a principal residence be made by the trust when the disposition occurs, either by sale or on the death of the widow. If this designation is not made, the exemption of the gain under the principal residence rules could be denied.

Chapter 11

THE HOBBY FARMER

What is a hobby farmer for income tax purposes?

To understand how our income tax law works with regard to farm income and farm losses, it is necessary to distinguish three types of farmers.

A. First of all, there is the person who carries on a farming operation but has no real expectation of ever making it a profitable venture. In such cases none of the expenses incurred are deductible for income tax purposes because they would not have been incurred for the purpose of earning income from a business. Instead, they would be considered to be personal or living expenses of the individual. Minor amounts of farm products sold would presumably not be subject to income tax either. Such a person would normally depend on a source of income other than his farming activities to provide for his needs.

B. Next, there is the person who can truly be said to be in the business of farming because there is a reasonable expectation of profit. However, farming is not his way of life and his chief source of income is not from farming nor a combination of farming and some other activity. Because he is engaged in the business of farming with the intention of making a profit he must report his revenue and may deduct the expenses incurred to earn it. This person is often called a hobby farmer or gentleman farmer. He is treated essentially the same as a bona-fide farmer except that he is restricted in the amount of the farm losses that he can claim and he is also not entitled to use the five-year block-averaging election.

   Persons who are part-time farmers will generally be included in this category. Whether or not farming or a combination of farming and some other activity constitute the person's chief source of income is the basic test in all cases. For simplicity we will refer to all persons in this category as hobby farmers.

C. The last category, of course, is the bona-fide farmer whose operations are unquestionably the chief source of his livelihood. All of the special advantages which exist for farmers under our law are available to him.

The facts in each case will always determine which of the three categories applies to a person. Many taxpayers have gone to court in an attempt to establish that they were hobby farmers or bona-fide farmers and were entitled to the restricted or full farming loss which Revenue Canada had disallowed. Despite the great number of these cases there continues to be some "grey areas"; particularly in the differentiation of a bona-fide farmer from a hobby farmer where the farming operation is large but does not constitute the individual's chief source of income.

Individuals who operate farming businesses in addition to having other income-earning activities should review Revenue Canada's Interpretation Bulletin IT-322R.

We thought that the best way to discuss the rules applying to the hobby farmer would be to ask a series of questions which might be asked by a person who falls into that category of farming. Here they are:

What are the loss restrictions for hobby farmers?

If a taxpayer's chief source of income is neither farming nor a combination of farming and some other source of income, a loss sustained from the business of farming is deductible from other income only to the extent of the lesser of:

A. the farming loss for the year, or

B. $2,500 plus the lesser of

1. one-half of the amount by which the farming loss for the year exceeds $2,500 or
2. $6,250.

This results in a maximum deduction of $8,750. In years commencing before 1989 this maximum was only $5,000.

The portion of the net farming loss that is not deductible against other income of the year is called a restricted farm loss. Such losses incurred in 1983 and subsequent years may generally be carried back three years and carried forward for ten years, but may be deducted only against farming income earned in those years. Losses incurred in 1982 and previous years may be carried back one year and carried forward for five years.

As mentioned above, the maximum annual farm loss that a hobby farmer can deduct from other income is $8,750. In order to obtain that deduction he has to realize an actual loss of at least $15,000. The deductible loss (if incurred in 1983 or subsequent years) may be carried back three years or forward ten years in accordance with the normal rules. A deductible loss in 1982 or previous years may be carried back one year or forward five years.

We should also add that, in cases where certain scientific research expenditures have been made, these expenses may be deducted in addition to the $8,750 allowed for the year.

Can hobby farmers use the cash method of accounting for their income?

Yes. As discussed in Chapter 3 the cash method can be used to report farm income by all persons who are in the business of farming. If your loss for the year exceeds the amount which would currently be deductible to you as a hobby farmer, you can bring in part or all of the value of your inventory and reduce the amount of your loss. This rule gives hobby farmers who have livestock or other inventories considerable flexibility as to the amount of income or loss which they may report. It is another good reason for a person in the farming business to use the cash method to report income.

Hobby farmers who are on the cash method are subject to the mandatory inventory adjustment rules if they report a loss (see Chapter 3).

Can a hobby farmer use the income-averaging which is available to a bona-fide farmer?

No. He cannot use the five-year block-averaging calculation because only individuals whose chief source of income is from farming can use that method.

Can hobby farmers use the special $1,000 per year exemption for gains on a principal residence which is situated on a farm?

Yes. As long as the property is a principal residence which is situated on land used in his farming business, it appears that a hobby farmer can use this special rule in the same manner as a bona-fide farmer. As we have outlined in Chapter 10, there are two ways in which a farmer can calculate the exempt portion of the capital gain arising on the disposition of his principal residence. He can either sever the principal residence portion from the rest of the farm to determine his exempt capital gain or he can take a special exemption of $1,000 plus $1,000 for each year he lived in the home.

Are corporations or partnerships subject to the hobby farm loss restrictions?

Yes. If neither farming nor a combination of farming and some other source of income can be said to be the chief source of income of a corporation then the loss restrictions will apply. Where the farm is carried on by a partnership the hobby farmer determination would be made for each member of the partnership. It is possible, therefore, for some members of a particular farming partnership to be treated as hobby farmers while other members would be treated as full-time farmers in their own right.

If a hobby farm is sold, what happens to the unused restricted farm losses? Are they completely unusable?

No. When a farming operation which has been subject to the hobby farm loss restrictions is disposed of, certain adjustments may be made to the cost base of the land for capital gains purposes to compensate for the fact that certain restricted farm losses have not been deductible. A special series of calculations is required to determine the portion of the restricted farm losses which can be added to the cost base of the land to minimize the capital gain.

Will hobby farmers get the same tax concessions as the bona-fide farmer when he disposes of farm property?

Generally yes. The rules discussed in Chapter 14 and Chapter 15 should be reviewed for details concerning farms owned at date of death or transferred to children during the owner's lifetime.

Can hobby farmers who are members of farming partnerships or people who own incorporated hobby farms defer income tax at date of death and at time of gift or sale of such assets to children?

Shares of a hobby-farm corporation do not qualify for the rollover at death or during the owner's lifetime. An interest in a farming partnership, on the other hand, may qualify provided that the owner, his spouse or a child was actively engaged in the particular farming operation and substantially all of the assets in the partnership were used in the business of farming.

Can hobby farmers benefit from the capital gains deduction in the same way as other farmers?

If the hobby farmer is an individual, the full capital gains deduction should be available in respect of the capital gain arising on the sale of qualified land, buildings and quota (see Chapter 12). If, on the other hand, the hobby farmer is a corporation, the shares of the corporation will not be treated as "qualified farm property". The owner of the shares will still be able to take advantage of the capital gains deduction - but only under the basic deduction applicable to non-farming property (see Chapter 12). If the hobby farmer is a member of a partnership, a capital gain arising on the sale of his partnership interest should be eligible for the full deduction provided the owner, his spouse or a child was actively engaged in the farming business and substantially all of the assets in the partnership were used in the business of farming.

Chapter 12

THE CAPITAL GAINS DEDUCTION

Introduction

One tax provision that is of special interest to you is the lifetime capital gains deduction, particularly now that it applies to quota gains. ***For most individuals, the lifetime deduction is limited to $100,000. Farmers, however, are given preferential treatment in that they are entitled to a $500,000 deduction if the capital gain arises from the sale of "qualified farm property" (see below).***

The deduction applies in respect of capital gains realized after 1984. Because three-quarters of capital gains are now subject to tax, the deduction will eliminate tax on up to $375,000 of taxable capital gains (3/4 x $500,000). In 1989, when the capital gains inclusion rate was two-thirds, the maximum deduction was $333,333.

The deduction is cumulative which means that the amount that can be claimed in any year can be affected by the amount claimed in previous years. If, for instance, you realized a capital gain from the sale of "qualified farm property" of $100,000 in 1985 and claimed a deduction in respect of the taxable portion of that gain, and then realized a further capital gain of $500,000 in 1989 from the sale of a similar property, the maximum deduction that could be claimed in 1989 would be calculated as follows:

Maximum deduction in 1989 (2/3 x $500,000)	$ 333,333
Less: Deduction claimed in 1985 (1/2 x $100,000) (see note)	50,000
Add: Adjustment as a result of increasing the capital gains inclusion rate from 1/2 to 2/3 (1/3 x 50,000)	16,666
	66,666
Deduction available in 1989	$ 266,667

Note: The capital gains inclusion rate in 1985 was only one-half.

Another method of calculating the 1989 deduction is as follows:

Maximum gain that can be realized without tax	$ 500,000
Gain exempted from tax in 1985	100,000
Future gains that can be realized without tax	400,000
Capital gains inclusion rate in 1989	2/3
Maximum deduction in respect of taxable gains (2/3 x 400,000)	$ 266,667

The $500,000 deduction that is available to individual farmers is best looked upon as a $100,000 deduction that is available in respect of the capital gain on any capital property plus an additional $400,000 deduction that is available only in respect of qualified farm property. If you use the whole $500,000 to offset a gain on a qualified farm property, you will have no further deduction available to you. If, however, you use $400,000 on farm property, the remaining $100,000 can be used for gains on other property. The $500,000 deduction is sometimes referred to as the enriched deduction and the $100,000 as the basic deduction.

Each member of the family is entitled to the deduction

There is no overall limit on the deduction that may be claimed by a family. In other words, if a farm is owned jointly by you and your spouse, each would be entitled to the enriched deduction and, in total, up to $1,000,000 of capital gains could be exempt from tax, provided the farm qualified (see below). If the farm was owned jointly by three children, up to $1,500,000 of capital gains could be exempt from tax. Again, the farm must qualify for the enriched deduction and this depends on the use to which it is put (see below).

The deduction is available only in respect of gains on capital property and quota

Because the deduction applies against taxable capital gains, it is available only where an individual disposes of a capital property and realizes a profit. Capital properties include land and buildings used in a farming business, shares in a farming corporation and an interest in a farming partnership. Livestock is not a capital property and any income from the sale of this asset will not be eligible for the deduction.

A portion of your quota gain is now eligible for the deduction (see Chapter 9) because the Income Tax Act deems it to be a taxable capital gain for purposes of the capital gains deduction rules.

Deduction available in respect of "deemed" dispositions

As discussed in Chapters 14 and 15, property is deemed to be disposed of when it is gifted to another person and when the owner dies. If this "deemed disposition" results in a capital gain, the owner (or his personal representatives) can take advantage of the capital gains deduction to eliminate the tax that would otherwise be payable.

What is qualified farm property?

In order to be treated as a "qualified farm property", the property must be owned by an individual or by his spouse or by a partnership, an interest in which is an "interest in a family farm partnership", and must be one of the following:

A. Land and buildings used in a farming business by:

- the individual, his spouse, or parent or any of his children;
- the beneficiary of certain personal trusts;
- a corporation, a share of which qualifies as a "share of the capital stock of a family farm corporation" (see below) of the individual, his spouse, parent or any of his children; or
- a partnership, an interest in which qualifies as a "interest in a family farm partnership" (see below) of the individual, his spouse, parent or any of his children;

B. Eligible capital property (eg. quotas) used in a farming business by one of the above;

C. A share of the capital stock of a family farm corporation (see below); or

D. An interest in a family farm partnership (see below).

Where the land and buildings (or quota) is acquired after June 17, 1987, a 24 month holding test must be met and either

- the property must be used by a family farm corporation or a family farm partnership for 24 months during which time the individual, his spouse, children or parent was actively engaged on a regular and continuous basis or

- the individual, spouse, children or parent who used the property must meet a gross revenue test for a 24 month period during which the property was owned.

A "share of the capital stock of a family farm corporation" is a share of a corporation whose assets consist substantially (at least 90%) of property used in a farming business in Canada or the shares and debt of other family farm corporations. An "interest in a family farm partnership" is an interest in a partnership whose assets consist substantially (at least 90%) of property used in a farming business in Canada. As a result of the 1987 Tax Reform, the farming property of a corporation or partnership, as the case may be, must have been used in the business of farming for at least 24 months, and the individual, his spouse, children or parent must have been actively involved in that business on a regular and continuous basis.

It is interesting to note that these definitions apply only for the capital gains deduction rules. The terms "family farm corporation" and "family farm partnership" are also used in connection with the parent-child rollover rules (see Chapters 14 and 15) but the definitions are not the same. In the rollover rules there is no 24 month test. More importantly, the farming business must be carried on by the partnership or corporation itself and not by a member of the family who is a member of the partnership or a shareholder of the corporation. Finally, the rollover rules require that the individual, his spouse or his children (not a parent) be actively involved - but not necessarily on a regular and continuous basis.

Land and buildings acquired before June 18, 1987 which are rented to a person outside the family by a retired farmer will be eligible for the full deduction, irrespective of the year of sale, provided the property (or the property for which that property was substituted) is sold after 1984 and was used in farming by the farmer, his spouse, parent or his child (or by their family farm corporation or family farm partnership):

- in the year the property was sold, or

- in at least five years during which the property was owned by the farmer, his spouse, parent or his child.

As noted above, the $500,000 capital gains deduction applies to land, buildings and quota owned by a partnership, an interest in which qualifies as a family farm partnership. If the partnership does not qualify as a family farm partnership (perhaps because more than 10% of its property is used in an activity other than farming) its land, buildings and quota would only be eligible for the $100,000 deduction.

What happens if you sell a capital property and take back debt?

If you sell capital property in exchange for debt, you are entitled to claim a reserve for income tax purposes in respect of the unpaid proceeds, which has the effect of spreading the capital gain over a number of years. If the property being sold is a "qualified farm property" (see above), the capital gains deduction can be claimed in each year in which a portion of the capital gain is included in income. Commencing in 1988 this is also true in respect of the capital gains deduction on properties other than "qualified farm property".

If you sold a capital property before 1985, any capital gains reserves carried forward into 1985 and future years are not eligible for the deduction.

As a result of the 1987 Tax Reform, reserves are generally not available in respect of the sale of quota after June 17, 1987.

What happens if a farmer sells a qualified farming property and other capital property?

This is best illustrated by an example. Assume that in 1989, you sell land, buildings and equipment and realize the following gains:

	Capital Gain	Taxable Portion	
Land	$ 120,000	$ 80,000	(2/3)
Buildings	60,000	40,000	(2/3)
Quota		200,000	
Equipment	30,000	20,000	(2/3)

Assume also that the land, buildings and quota were used by you in farming such that they meet the definition of "qualified farm property".

In this situation you would be entitled to the following capital gains deduction:

In respect of your "qualified farm property" (eg. your land, buildings and quota)	$ 320,000
In respect of your other property (eg. your equipment) (but limited by your maximum deduction)	8,333
Maximum deduction	$ 333,333

Note that a sale of buildings and equipment may also give rise to recaptured depreciation. This type of income is not eligible for the capital gains deduction, nor is the recapture of previous quota write-offs that can arise on a sale of quota. Note also that the capital gains inclusion rate for land and buildings and equipment increased to three-quarters in 1990.

Impact of claiming certain types of capital losses in previous years

If you deduct certain special types of capital losses from ordinary income then future capital gains, up to the amount of these losses, are not eligible for the capital gains deduction. The special types of capital losses which can be deducted from ordinary income are:

- net capital losses which were incurred before May 23, 1985 (and which may be deducted from ordinary income at the rate of up to $2,000 per year); and

- allowable business investment losses arising on the shares and debts of certain small business corporations (which may be deducted from ordinary income without limitation - provided you have not previously claimed the capital gains deduction).

What happens if the farm is owned by a corporation?

The corporation itself will not be able to claim the capital gains deduction because the deduction is available only to individuals and certain trusts. As a shareholder, you can still take advantage of the deduction, however, by arranging to sell the shares of your corporation. Provided the corporation is such that a share qualifies as a "share of the capital stock of a family farm corporation" (see above), the full deduction will be available in respect of a sale after 1984.

What happens if the farm is owned by a partnership?

If the partnership sells qualified farm property (eg. quota, land and buildings) the capital gains flow through to the individual partners and are eligible for the capital gains

deduction in their hands. The partnership must be such that the interest held by each of the individual partners qualifies as an "interest in a family farm partnership".

In non-arm's length situations (such as between a parent and child) the farmer may sell his partnership interest. Assuming it is an "interest in a family farm partnership", the farmer will be eligible for the $500,000 deduction.

Investment expenses - a possible roadblock between you and your deduction

As a result of the 1987 Tax Reform, there is another possible roadblock between you and your capital gains deduction if you have incurred "investment" expenses. Investment expenses are defined in the Income Tax Act as including interest relating to passive investments, rental losses and certain tax shelter deductions. These expenses (together with offsetting investment income) have to be tracked from the beginning of 1988 onwards. If at the end of a particular year in which you have realized a taxable capital gain, your accumulated investment expenses exceed your investment income - your entitlement to the capital gains deduction will be restricted. This can be illustrated as follows:

Assume:	
Taxable capital gain realized in 1989	$ 90,000
Accumulated investment expenses, net of investment income, at the end of the year	$ 10,000
Then:	
Taxable capital gain that is eligible for the deduction (90,000 - 10,000)	$ 80,000
Taxable capital gain that remains subject to tax	$ 10,000

Fortunately this will not likely impact on too many farmers. ***Farmers who borrow to acquire shares of a farm corporation could be affected, and should ensure they receive advice from their accountant on how to deal with the problem.***

Will this deduction be available forever?

Who knows! We had a major "Tax Reform" almost twenty years ago and we have had mini-reforms at intervals since that time. ***Tax incentives of one year are sometimes looked upon as loopholes in the next.***

Some individuals with large accrued capital gains on their farms have been sufficiently concerned about the possibility of losing this deduction that they have "locked in" their entitlements by transferring their businesses to corporations. Their land would have been transferred at fair market value and they would have claimed the capital gains deduction to eliminate the tax that would otherwise have been payable.

This strategy would not likely be appropriate for buildings because the sale to the company would probably result in recaptured depreciation. In addition, there is a rule in the Income Tax Act that reduces the capital cost of the property to the purchaser to the extent that the non-arm's length seller has claimed the capital gains deduction. There is a similar anti-avoidance rule dealing with quota.

The incorporation of your farm to take advantage of the capital gains deduction should be proceeded with only after receiving expert advice. The person providing that advice has to concern himself not only with regular income taxes but also the alternative minimum tax (see Chapter 13), the Social Services Tax Act (sales tax) and the Property Purchase Tax Act.

Chapter 13

THE ALTERNATIVE MINIMUM TAX

Introduction

In response to criticism that individuals earning substantial incomes could avoid paying tax by investing in tax shelters, the government introduced the concept of a "minimum tax". This tax, which commenced in 1986, affects not only the individuals who purchase tax-sheltered investments but also those who realize substantial capital gains. To some extent, the new tax undermines what the government is attempting to do through the capital gains deduction. On the one hand the government is attempting to encourage investment in Canada by giving individuals a generous capital gains deduction and, on the other, it penalizes individuals if they realize a significant profit from their investments.

The tax is of considerable importance to farmers because they will often realize a capital gain when they retire from farming. The gain might arise when the farm is transferred to the next generation (if the farmer chooses not to use the rollover rules - see Chapter 15) or when it is sold to an arm's length purchaser. Fortunately, the taxable capital gain arising from a sale of quota will not cause the minimum tax rules to apply.

Conceptually, the new tax calculation is not too difficult to understand but, in practice, there are several complexities. As a result, you should always seek advice from your accountant if you think the new tax might apply. ***This advice should be sought a considerable time before entering into a transaction that might bring the new tax rules into play, so that the accountant has an opportunity of considering whether anything can be done to help you.***

In essence, individuals who may be affected by the new rules have two tax calculations to make. First, they must calculate their liability to the federal government under the regular method and then they must calculate their liability for the "alternative minimum tax" (AMT). If the AMT liability is higher, then:

- the individual's federal tax liability for the year becomes the higher amount;
- individual's provincial tax liability for the year is based on the higher amount;
- the excess of the AMT over the regular tax is available for carry-forward for up to seven years;
- the carry-forward can be deducted from the individual's regular tax liability in any of the next seven years - but the amount that can be deducted in any one year cannot reduce the liability below the AMT for that year.

The above mechanism is best illustrated by an example:

Assume:

Year	Regular Tax	AMT
1989	$ 20,000	$ 25,000
1990	10,000	9,000
1991	8,000	NIL
Total	$ 38,000	$ 34,000

In this example, the individual's tax liability for 1989 would be $25,000 and the $5,000 AMT carry forward ($25,000 - $20,000) would be applied to reduce the regular tax liability in 1990 and 1991 by the following amounts:

1990	$ 1,000
1991	4,000

The revised liability of the individual would, therefore, be as follows:

1989	$ 25,000
1990	9,000
1991	4,000
	$ 38,000

How is the AMT calculated?

In general terms, the AMT is calculated by taking the taxable income calculated for regular income tax purposes and adjusting it for certain "preference" items (see below). The resulting figure is then reduced by a basic exemption of $40,000 and is multiplied by a tax rate of 17% to arrive at the federal AMT. This AMT is compared to the federal liability under the regular method to determine if the AMT applies.

The adjustments that are made to taxable income to arrive at the base on which the AMT is calculated include the following:

Taxable income is increased by the so-called "preference" items:

- the non-taxable portion of capital gains (including those which are eligible for the capital gains deduction ***but excluding quota gains***);
- contributions to retirement plans; and
- tax shelter deductions - to the extent that losses are created by deductions for Canadian exploration expenses, Canadian development expenses, Canadian oil and gas property expenses or capital cost allowance on multi-unit residential buildings or film properties.

Taxable income is reduced by:

- the "gross-up" included in income in respect of taxable dividends from Canadian corporations; and
- the basic exemption of $40,000.

Revenue Canada has developed a special form (T691) to enable individuals to make the required calculations.

How do you know if the AMT will apply?

There is no magic formula to determine this - each individual who is planning a transaction that will result in a significant capital gain has to be aware that the AMT could apply. Generally speaking, if the so-called "preference" items summarized above (particularly the first two - because they are the items that will normally affect your return) will exceed $40,000, you should request your accountant to make the AMT calculations. ***You should always consider the AMT when selling your farm or transferring it to your children.***

What happens on death?

As explained in Chapter 14, an individual is deemed to dispose of his assets immediately before his death. ***Fortunately, this does not create a problem because AMT no longer applies to a deceased taxpayer's final return.***

Is there any other situation where the AMT does not apply?

There is an important exception in the AMT rules in that they do not apply in the year in which you elect to block-average. This is an added reason for you to use your block-averaging election carefully.

The AMT rules also do not apply to certain separate returns that can be filed in some situations.

Chapter 14

WHAT WILL HAPPEN TO THE FAMILY FARM WHEN YOU DIE?

What tax consequences arise when the owner of a farming business dies? There is no simple set of answers to this question, unfortunately, since every person's circumstances will be different. The taxes arising at the time of death could be nil in some cases, could be quite staggering in others, and will be somewhere in between for the majority.

Even though we now have a capital gains deduction (see Chapter 12) and this will eliminate most of the tax that may otherwise have arisen on death, it continues to be necessary to exercise care and to put in place some good financial and tax planning measures. After all, the farm property represents the major asset of most farmers. It has to be preserved in a sound financial position for the beneficiaries of your estate if they are going to carry on the business. In this chapter we will not have space to consider all of the ways in which taxes may be reduced when a person dies. We will limit our discussion to the areas which we believe to be of importance to farmers from the standpoint of income taxes. These areas are:

A. The necessity of making a will.

B. The federal income tax rules relating to capital property and depreciable property at the time of death.

A. The necessity of making a will

This is a matter that cannot be stressed enough; yet, in spite of its importance, many people in British Columbia die every year without having made a valid will, causing a great deal of unnecessary problems for those left behind. In a nut shell, by making a will you leave instructions as to how your worldly possessions are to be distributed when you die. The person or persons who are named as executors of your estate will collect together your assets, pay off your debts, and divide the remaining property in the way in which your will directs. Alternatively, the trustees you appointed will hold the property in trust for a period of time according to the terms and conditions established by you.

But what happens if you die without a will? In this case there will be no executor to look after things since no will was drawn up appointing one. Your next of kin may apply to the courts in order to be appointed as an administrator of your estate. Problems can arise at this point if no one can be found to act as an administrator or if several eligible persons argue among themselves as to who should get the job. The public trustee may then be appointed by the courts to act in this capacity. As to the division of your property, your wishes, regardless of what they might have been, will have no influence on how the property is actually divided. Since your wishes would not have been spelled out in a legally valid will they cannot be enforced. Instead, the property will be distributed strictly according to the rules laid down in the Estate Administration Act, which may bear no relationship to what you really wanted. Making a will can often be one of those things that you always meant to look into but somehow never quite got around to. Do so as soon as possible! Husbands and wives should each meet with a lawyer and prepare a will, if for no other reason than to avoid the administrative problems which arise when a person dies intestate (without a valid will). Wills can easily be changed, so they should be reviewed at regular intervals to make sure they reflect your wishes and your current financial circumstances.

More detailed information is available in the Ministry of Agriculture and Fisheries booklet "Wills for B.C. Farmers".

B. The federal income tax rules relating to capital property (including depreciable property) at the time of death

At the time of your death you will be considered to have disposed of certain property. As a farmer, this will include your farm land, buildings, machinery and equipment, vehicles, and any other assets which fall into the category of capital property (including depreciable property). Special rules exist for your cash basis inventories such as livestock and crops (see chapter 6) and your eligible capital property such as quota (see chapter 9). There are also rules applying to certain resource properties and parcels of land which are held as inventory.

As a result of the deemed disposition of your capital property at death, your accrued taxable capital gains and recaptured capital cost allowances will be included in your final personal income tax return unless one of the "rollover" rules applies (see below). Of course it is only those capital gains arising since V-day that are subject to tax. But as time goes on, particularly if there is a renewed inflationary trend in our economy, you might realize a large capital gain on your land. If you own substantial machinery and equipment you may also have a large potential for recaptured capital cost allowance. As we move further away from V-day, the accrued tax liabilities on your farm property will increase.

Of course, we now have the capital gains deduction (see Chapter 12) and this has reduced the tax cost of a fair market value disposition at the time of your death. The tax problem is not eliminated, however, because there remains the potential for recaptured capital cost allowance which cannot be offset by the capital gains deduction. Accordingly, the rules in the Income Tax Act that provide for a "rollover" where property passes to your spouse or children continue to be important.

The first of the rollovers referred to in this Chapter is the spouse rollover and is available to anyone (including a farmer) who leaves property to a husband or wife. The second rollover has been described as the farm rollover because it is available only to farmers.

These rollovers, together with the capital gains deduction, are the most important income tax considerations for owners of family farms in Canada.

1. The spouse rollover

Simply stated, this rule provides that when capital property is left to a spouse, taxable capital gains and recaptured capital cost allowance which would apply under the general rule are deferred until a later date. The tax liability is put off until the surviving spouse's death, at which time the taxable capital gains and recaptured capital cost allowance must be reported in the spouse's final income tax return unless, in the case of farm property, there is a further rollover in respect of the property transferred to a child. The deferral of tax will apply whether the property is bequeathed to the spouse absolutely or is distributed to a trust for the spouse for the rest of her lifetime. If a trust is used, certain requirements must be met and these should be carefully considered at the time a person's will is drafted. Your lawyer or accountant should be aware of these requirements and can advise you accordingly. ***If all the criteria are not met, then the trust will not qualify and the rollover treatment will be denied.***

The purpose of this special rule is to recognize, in a limited way, the sense of community of property which normally exists between husband and wife. Of course, both husband and wife have equal status under the law as to ownership of property in their own right. But the family unit is respected in the Income Tax

Act and the tax collector does not insist on taking his share of the family's accumulating wealth until the property passes to the next generation.

Now, because there is a rollover for capital property passing to your spouse, it does not mean that your executors should always use it. If you have not used your lifetime capital gains deduction (see Chapter 12), it may be appropriate for your executors to elect to have some of your property disposed of at fair market value. The capital gain that would be created would be offset by the capital gains deduction and your spouse would then have a higher cost to compute her ultimate capital gain on the property.

2. The farm rollover for unincorporated family farms

Provided that certain criteria are met, certain capital property used in a farm can be transferred from one generation to the next without tax cost. Before 1985, this property simply "rolled" to the next generation - meaning that the new owners simply assumed the position of the deceased parent and the accrued tax liability was deferred until a later time. ***Under the new rules, your executors have considerably more flexibility. They can elect to have the property deemed to be disposed of at its tax value (or "rollover" value) or at any higher amount that is not in excess of the property's fair market value.*** The amount elected becomes the cost to the new owner as well as the proceeds to you. This election mechanism allows your executors to take advantage of your unused capital gains deduction and to "step-up" the cost of the property to the next generation.

Summarized below are the types of property that qualify for this treatment and the conditions that must be met:

a) Canadian property only

The property must be land or depreciable property which is situated in Canada. Only depreciable property on the declining balance basis will qualify. Straight-line depreciable property must be transferred at fair market value. As mentioned previously,special rules apply to agricultural quotas and to your cash basis inventories which will allow these properties to be "rolled to" a child as well. Inventories of accrual basis farmers are not deemed to be disposed of at the time of death.

b) Owned by the farmer

The property must be owned by you at the date of death. An unincorporated farm owned jointly by you and your children or your spouse would qualify for rollover.

c) Used in the business of farming

Immediately before your death the property must have been used by you or your spouse or any of your children in the business of farming. Note that there is no rule which requires your children to carry on the farming business for any specified period of time after your death. Note also that the owner of the property himself does not necessarily have to have been the individual who was in the business of farming. Thus, in a situation where you have retired and lease the farm to your children, the rollover rules will still operate.

The rollover rules will also operate if the property was leased to a "family farm corporation" or a "family farm partnership". These are defined terms in the Income Tax Act which describe corporations and partnerships which use substantially all of their assets in the family's farming business. If the property is rented to a stranger at the time of your death, the rollover rule will not apply and the property will be deemed to be disposed of at fair market value.

d) Bequeathed to a child, grandchild or great-grandchild

The farm property must be bequeathed to your child, grandchild or great-grandchild who is resident in Canada at the time that you die. Note that the word "child" has a special meaning for purposes of the Income Tax Act. It includes an illegitimate child, a son-in-law or daughter-in-law and adopted children.

Even though the Income Tax Act requires that the farm property must pass directly to a child, Revenue Canada's administrative practice is to allow the rollover to apply if the property passes to a trust for a minor child, in certain situations. The property must vest indefeasibly in the beneficiary. For further information you should review Revenue Canada's Interpretation Bulletins IT-349R and IT-449.

e) Transfer of ownership of property within 36 months

The ownership of the property must be transferred to the beneficiary of the estate within 36 months.

These are the rules which must be met if the rollover rules are to apply. It is conceivable that income tax could be postponed indefinitely if the farm continues to be passed from one generation to the next.

3. Extension of the farm rollover rules to include shares of a family farm corporation and an interest in a family farm partnership.

Effective for deaths occurring after April 10, 1978, shares of a family farm corporation and an interest in a family farm partnership will qualify for the "rollover" treatment when they pass to your child. Your executors have the ability to elect to transfer this type of property for any amount between your adjusted cost base (the "rollover value") and fair market value.

4. Extension of rollover rules to include a purchase by a child from the deceased's estate

In the past, the farm rollover was available only where the property passed to the next generation ***as a consequence of the death of the parent***. The Courts interpreted the phrase in italics as meaning that the estate couldn't sell the property to one or more of the deceased's children. If it did, the property was deemed to be disposed of by the deceased parent at fair market value - regardless of the selling price to the child.

As a result of an amendment to the Act in 1985 (retroactive to 1981) this is no longer a problem. If your will provides that your land and buildings are to be sold by your estate to your child at say 60% of their fair market value, your executors will still have the ability to designate the deemed proceeds

to be any amount between the property's "rollover" value and its fair market value (provided all criteria are met - see above).

5. Extension of rollover rules to property transferred from a deceased child to a parent

Land, depreciable property written off on the reducing balance basis, a share in a family farm corporation or an interest in a family farm partnership that is transferred on a rollover basis by a parent to a child, and is then transferred back again as a result of the death of a child can be "rolled" to the parent. The child's executor has to elect for this rollover rule to apply by including a statement to that effect in the child's final tax return.

6. Combination of spouse rollover and farm rollover

You may want to transfer your farm to your child on your death and to do it in a manner that will enable your surviving spouse to receive the income from the farm for the remainder of his or her lifetime. You can do this by using a spouse trust. There will be a rollover when the farm passes to the trust and a further rollover when it passes out of the trust to your child.

This arrangement is not often used by farmers, but it does ensure that the farm is inherited by the children and the surviving spouse is looked after during the remainder of his or her lifetime. Effectively, the spouse trust combines the rollover that is available when property is transferred to a spouse and the rollover for property transferred directly to children.

In order for the rollover to apply, the trust for your spouse must first meet all of the normal tests necessary for the spouse rollover. Either a trust arising at the time of death or a trust established while you are alive will qualify.

The rules with respect to this combination rollover are summarized below:

a) Canadian property

This test is identical to the one discussed earlier in this Chapter.

b) Qualified spousal trust

The property must be transferred to a qualified spousal trust, whether this is a trust arising on your death or a trust established during your lifetime. Your accountant or lawyer will be aware of the requirements that must be met in order for the trust to qualify for the rollover.

c) Used in farming

Immediately before the death of your spouse, (i.e., the person for whom the spousal trust was originally set up) the property must have been used in the business of farming. Note that under the present wording of the law your spouse, children or grandchildren need not be involved in the farming business. An independent manager, for example, could be hired to run the farm for the benefit of the beneficiaries. Alternatively, the land and buildings could be rented to another person for use by him in his farming business.

d) Vesting on death of the spouse

When your spouse dies, the property must be transferred or distributed to your child or children who are resident in Canada at the time of your spouse's death.

As with direct transfers of Canadian farm property (see earlier comments) the trustees can elect to have the trust dispose of the property at its "rollover" amount or at any higher value that is not in excess of its fair market value.

7. Some special rules concerning family farm corporations and interests in a family farm partnership held by a spousal trust

The rollover for farm corporations and farm partnerships will also apply in situations where the property is first transferred to a spousal trust. Some particular planning points should be noted in this regard:

a) New trusts and trusts already established

The rollover will apply, effective April 10, 1978 (the date of the amendment to the law), for qualifying spousal trusts already in existence or for spousal trusts set up after that date.

b) Children resident in Canada

The child who ultimately inherits the property must be resident in Canada immediately before the death of your spouse. This rule becomes important in a situation where, for example, a taxpayer dies while his child is living in the United States. As long as the child takes up residence in Canada before the death of the second spouse, the rollover rule would operate.

c) Family farm partnerships or corporations

The rules allow a family farm owned by a partnership or corporation to be operated and managed by a person not related to the family members. It is important to note, however, that the corporation or partnership cannot lease its farming property to another entity; it must use the property in its own farming business.

d) The ultimate transfer to the children

Provided all of the technical rules for the spousal trust are met, then at the date of death of the second spouse, the rollover to the children will be available. The normal rule regarding a deemed disposition of a trust's capital property every 21 years will not apply to this particular trust.

Again, where there is an accrued gain on the property owned by the trust, the trustees can elect to distribute the property to the children at any amount between its "rollover" amount and its fair market value.

That is a short summary of the federal income tax consequences which are applicable at the time of your death or at the time of the death of your spouse. If proper tax planning arrangements are made in your will, then major income tax problems can usually be avoided or deferred. The family farm corporation and family farm partnership rollovers are very beneficial to you. They permit you to take advantage of the tax deferrals and income-splitting possibilities that are provided by corporations and partnerships without sacrificing any flexibility in your estate planning.

Chapter 15

WHAT YOU SHOULD KNOW ABOUT GIFTS

When a resident of British Columbia makes a gift of cash or other property of any kind to another person he should be aware that tax implications may arise from his generosity. Even though we no longer have a gift tax in British Columbia, some income tax implications do remain. ***Gifts of property as such are not subject to tax under the federal Income Tax Act, but a disposition of property by gift may give rise to income tax on a capital gain or a recapture of capital cost allowance.*** A gift of land and buildings, for example, could have this result. There are special rules concerning the income arising from gifted property as well. These rules will be of interest where gifts are made to a spouse or to minor children.

If a gift of property has the effect of creating a capital gain for income tax purposes, the person making the gift may be able to claim the capital gains deduction (see Chapter 12). If the capital gain is significant, the alternative minimum tax rules may apply (see Chapter 13).

What form should a gift take?

Wherever possible, gifts should be made in cash, preferably by cheque. This general rule was followed during the time the British Columbia Gift Tax Act was in effect and it makes good sense from the standpoint of the federal income tax rules as well. There are several advantages to this approach.

A. It's easy.

B. It provides good documentation (in the form of the paid cheque) of the amount of the gift, the name of the person who received it, the date on which it was made and its acceptance by the person receiving it.

If it is not possible to make the gift in the form of cash, then special attention must be paid to certain income tax rules, which are discussed below.

What are the tax implications of making a gift?

As we noted before, the value of a gift is not subject to income taxes. But everyone should be aware that when property of any kind is gifted it is generally deemed to be disposed of at fair market value. As a result, accrued taxable capital gains or recaptured capital cost allowances will have to be reported in the income tax return of the person making the gift. The lifetime capital gains deduction may eliminate the taxable capital gain but will not offset the recaptured capital cost allowances.

What about a gift to a spouse?

If property other than cash is gifted between a husband and wife, the transfer is deemed to occur on a "rollover" basis. In other words, the person receiving the property inherits the transferor's cost and the accrued capital gain or recaptured capital cost allowance is deferred until the property is disposed of to a third party or the recipient of the property dies. This deferral rule applies automatically unless the person making the gift elects to have the property disposed of at fair market value. If this election is made, the person receiving the gift is deemed to acquire the property at fair market value.

The fair market value election can be useful if the transferor spouse has unutilized capital losses or wants to claim their unused capital gains deduction. As mentioned previously, it will be necessary to consider the alternative minimum tax.

"Farm rollovers" to children

Most of the rules dealing with the transfer of farming property to children on the death of a parent (see Chapter 14) also apply to transfers during the parents' lifetime. ***This means that most farm property can be transferred to your children on a "rollover" basis.***

As with transfers on death, you can choose to sell certain types of property to your children at an amount which exceeds your "rollover" amount. You may wish to do this if you have losses which you want to utilize or if you are able to claim the capital gains deduction. The property which is eligible for this special treatment includes land, buildings, intangible assets (such as quota), shares of a family farm corporation and an interest in a family farm partnership.

If we assume, for instance, that a farmer owns land which has a cost of $100,000 and a fair market value of $250,000, he has the following options:

- he can simply gift the property to his children - in which case his proceeds for tax purposes will be deemed to be equal to his cost - $100,000; or

- he can sell the property to his children at any value he chooses and, generally speaking, the amount chosen will represent his proceeds of disposition for income tax purposes. However if the sales price is less than $100,000, his deemed proceeds will be increased to this amount. If the sales price is more than $250,000, his deemed proceeds will be reduced to that amount.

In order for you to take advantage of the special rules applying to land, depreciable property and quota, the following conditions must be met:

A. Canadian property

The assets must be used in a farming business carried on in Canada. The depreciable property must be written off on the declining balance basis rather than on the straight line basis permitted for assets acquired before 1972.

B. Owned by the farmer

The property must have been owned by you prior to the transfer.

C. Used in the business of farming

Immediately before the transfer of property is made, the property must have been used by you, your spouse or any of your children in the business of farming. If the property is leased to a family farm corporation or a family farm partnership, for use in its farming business, it will be treated as being used in farming by you and will be eligible for the special "rollover" rules.

D. Transferred to a child, grandchild or great-grandchild

The farm property must be given to your child, grandchild or great-grandchild. This person must also be a resident of Canada. Special note should be made of the fact that the definition of a "child" for this purpose will include an illegitimate child, a son-in-law or daughter-in-law and an adopted child. In certain cases other children over whom you may have had custody and control during his or her childhood may also qualify.

Even though the Income Tax Act requires that the farm property be transferred directly to a child, Revenue Canada's present administrative practice is to allow the rollover to apply where the property passes to a partnership, where all of the partners are your children. A

rollover is also permitted where property passes to trusts for minors, in certain situations. For more information you should read Interpretation Bulletin IT-268R2.

Inventory of a cash-basis farmer

If you compute income on the cash basis, you cannot transfer your inventory to your child on a rollover basis during your lifetime. Property of this nature that is gifted to your child will be deemed to be disposed of at fair market value and the resulting income will be taxed in the year the gift is made.

Farm corporations and farm partnerships

As mentioned previously, the shares of a family farm corporation and an interest in a family farm partnership may be gifted to children on a "rollover" basis or may be sold at any value above the "rollover" amount - provided the sale price selected does not exceed fair market value. The term "share in a family farm corporation" is defined in the Income Tax Act as meaning:

A. A share of the capital stock of a corporation that carries on the business of farming in Canada.

B. The corporation must use all or substantially all of its property in the carrying on of that farming business.

C. You, your spouse, or your child must be actively engaged in the farming operation.

The phrase "substantially all" is interpreted by Revenue Canada to mean at least 90%. A property will be considered to be used in the business of farming if its primary or principal use (i.e. more than 50% of its use) is in farming.

An "interest in a family farm partnership " is defined as follows:

A. An interest in a partnership that carries on the business of farming in Canada.

B. All or substantially all of the property of the partnership must be used in carrying on that farming business.

C. You, your spouse, or your child must be actively engaged in carrying on the business.

As in the case of the family farm corporation, the words "substantially all of the property" are used. Presumably this would be less of a problem for a partnership than a corporation since the partnership would not normally accumulate non-farm assets in its own name as would a corporation which had undistributed surplus.

It is to be noted that the use of a corporation or partnership effectively allows a cash basis inventory to be transferred to your child during your lifetime.

The rollover privilege with regard to corporations and partnerships is beneficial for British Columbia farmers. Keep these rules in mind with regard to your estate and financial planning.

Also keep in mind that the definition of a family farm corporation and family farm partnership for the purposes of these rollover rules is slightly different than the equivalent definitions in the capital gains deduction rules. The differences are discussed in Chapter 12. Conceivably a partnership or corporation could be eligible for the rollover and not the deduction or vice versa.

Are there any other federal income tax consequences as a result of making gifts?

As a final note, it is important to be aware of the special rules that apply where property is gifted to spouses or children. These special rules are known as the attribution rules and their purpose is quite simple. One person (being the minor child or spouse who receives the transferred property) may earn income from the transferred property or may realize a capital gain on the disposition of that property but another person, the original owner, has to pay the relevant income tax. The rules are specifically designed to prevent improper income splitting arrangements between husband and wife or between parent and child. These are some items to watch for:

A. Income from property which you transfer to your spouse or to any person under the age of 18

This income is taxable on your tax return, not on your spouse's return or the minor child's tax return. In the case of your wife, or husband, this rule will apply as long as you remain alive, legally married and resident in Canada. In the case of children, the rule continues to apply until the year the child reaches the age of 18. However, if the gifted property is used in a business such as a farming business, these rules may not apply regardless of the child's age. Similarly, property transferred between husband and wife which is specifically used in a business operation, such as a farm, will not be subject to the income attribution rules.

B. Capital gains on property transferred to your spouse or a minor child

The same principle that applies to the income from property transferred to a spouse also applies to capital gains and capital losses realized on the disposition of such property. In regards to property transferred to a spouse, there is no attribution of capital gains if the original transfer took place before 1972. If it took place after 1971, only gains and losses arising after that date will be affected.

Capital gains on property transferred to minor children do not generally attribute back to the person who formerly owned the property. There is one important exception to that rule, however, which is of interest to farmers and is discussed below.

C. Farm property transferred to minor children

If you transfer farm property to a minor child and the child sells or disposes of it before the year in which he or she reaches age 18, any capital gain or loss on the property will be taxed in your hands. A situation like this will not happen too often, but it is something to be aware of, nonetheless. The rule is necessary so that the tax law is not abused when the sale of a farm to a third party is contemplated. If a farmer first of all sells the farm to his children, and then the children sell the farm to a third party, the capital gain and recaptured capital cost allowance would be taxable in the hands of the children (probably at lower rates of tax) and the family would be able to take advantage of the children's capital gains deduction. This type of arrangement might still be possible, however, but only if the sale to a third party takes place after the children reach the age of 18.

D. Farm property sold to a spouse

The attribution rules described above dealing with property transferred to a spouse will not apply if the property is sold to the spouse at fair market value (rather than being gifted) and the following conditions are met:

1. The transferor spouse elects to have the property disposed of for tax purposes at fair market value, and

2. The transferee spouse pays for the property transferred, or issues a note as part of the purchase consideration, and pays interest on the note within thirty days of the end of each year at a rate that is not less than the "prescribed" rate in the Income Tax Act.

It should be noted that our discussion of the income attribution levels deals only with certain basic principles. Whenever you are considering the transfer of property to a spouse or to a minor child, you should review Revenue Canada's bulletins and thoroughly investigate the income tax consequences.

There may often be situations where both a husband and wife have separate sources of income and each accumulates savings or investments in his or her own right. In a case where a person has a farming business, for example, and his wife works in town for a few years to help him get established, any income which is derived from the wife's savings will always remain taxable in her hands. Since it is usually beneficial from an income tax point of view to be able to split income between a husband and wife, it is important that a farmer and his wife be able to prove where such funds originated. If no record is kept, and the wife has ceased to work, the tax authorities might take the position that the funds in question had originally come from the husband's earnings. In such a situation the investment income would be taxable in his hands rather than hers. To avoid any such unjust application of the attribution rules, it is prudent to keep a separate accounting for each spouse's earnings and savings. In that way the income tax authorities can be readily convinced that nothing improper has been done in the reporting of the income and payment of tax.

Property Purchase Tax Act - can it apply on a transfer of the family farm within the family?

Yes it can. There is an exemption in respect of family farms if the property is transferred to a related individual or to a family farm corporation where all of the shareholders are related to the person making the transfer. The problem here is that the term "family farm" is defined restrictively and the term "related individuals" does not include brothers and sisters. If, for instance, land was rented to a family farm corporation and was then transferred to that corporation - the transaction would be taxable. Farm property transferred between two brothers, a brother and sister or between two sisters would be taxable. Similarly, if an individual transfers property to a corporation in which his brother or his sister is a shareholder, that would be taxable too.

The fact that the Property Purchase Tax Act will apply to a transaction may not prevent you from going ahead with it. The tax is 1% of the first $200,000 of value and 2% of the remainder. It applies only to the value of the land and the improvements. However, this matter should be looked at in advance - it is not very pleasant to receive an unexpected bill for several thousand dollars.

What about provincial sales taxes - can they apply too?

Quite possibly. Provincial sales tax doesn't apply to real property and there is a long list of exempt agricultural equipment which it doesn't apply to either. But there are some farm assets which are not exempt, such as automobiles.

Chapter 16

SELLING A FARM

A person in the business of farming may decide, for various reasons, to sell his farming operation. Retirement, poor health or simply a decision to give up farming may result in a decision to sell. In some cases, there may be a wish to sell the farm to those members of the family who have the desire and ability to carry on the business. In other situations a sale to a third party will be necessary. Whatever the circumstances, the sale of a farm is a complex transaction. There are many factors which should be taken into account before such a sale is made. In this study we are concerned of course with only the tax implications of such a sale, although there will also be numerous non-tax considerations. The more knowledgeable a person makes himself before the sale, the better able he will be to utilize any tax savings which are available to him. And, more importantly, he will be able to avoid those tax pitfalls which cause unduly harsh treatment at the hands of the tax collector. ***We would urge all persons who contemplate the sale of their farms to seek sound tax advice before entering into such a transaction. Preferably, they will seek this advice one or two years before the sale.***

From a layman's viewpoint, the tax consequences resulting from the sale of a farm can be summarized by answering the following nine questions:

A. Who is selling and when is it going to occur?
B. What is he selling?
C. To whom?
D. For how much?
E. How will payment be made and what will it be applied to?
F. How will any unpaid balance of the sale price be secured?
G. What will he do with the money?
H. When did he last block average?
I. What will be his income in the year of sale and in the next seven years?

On the surface these questions appear quite simple. For example, a farmer going out of business might say "I'm selling my land, buildings, equipment, quota and livestock to my neighbour for fair market value. The sale will take place at the end of the month. He will pay me 20 percent down and the balance over the next four years under an agreement for sale which calls for a yearly instalment with interest on the unpaid balance at commercial lending rates. I plan to put the money in term deposits and live off the interest during my retirement. I last block averaged three years ago. In the year of sale my farming income (ignoring the income from the sale of assets) will be $20,000 and in the subsequent seven years my income will consist only of what I earn on the agreement for sale and my term deposits." Fair enough. This is a good outline of the proposed sale. But let us examine more closely some of our simple questions and see what tax problems lurk behind the straightforward answers which we gave. Let's look at our first question:

A. <u>Who is selling and when is it going to occur?</u>

It will be relevant to determine whether it is a proprietorship, partnership or corporation selling the farm and when its fiscal period ends. If for instance, we are looking at the situation of a proprietorship with a non-calendar fiscal period and the sale is structured so that it occurs at the beginning of a fiscal period, the capital gains will be included in income in the calendar year in which the sale occurs and the recaptured depreciation and the income from selling inventory will be included in income in the following year.

To illustrate this principle let's assume that you have a June 30 year end and arrange to sell your land, buildings and livestock on July 1, 1989. The taxable capital gain arising on the sale of the land and buildings will be reported in your 1989 tax return because this type of income is always reported on a calendar year basis. The income arising on the

sale of your livestock, and the recaptured depreciation on the sale of your building can, however, be deferred until the 1990 taxation year (provided you make the appropriate election), even though you may cease to carry on business on July 1, 1989.

If the taxpayer is a corporation it may make sense for a portion of the ordinary income (eg. recaptured depreciation and the income from the sale of the livestock) to be spread over the two years. This could be done by selling some or all of the livestock on June 30 and selling the land and building on July 1. The same result could be obtained by placing an optional value on the company's June 30 livestock inventory (see Chapter 3) which would be deducted from income in the year commencing July 1.

All taxpayers should be able to obtain tax benefits by structuring the sale so that it occurs over two fiscal periods.

If the taxpayer is an individual or an individual member of a partnership, it is likely that the $500,000 capital gains deduction will apply. If the properties are owned jointly by the farmer and his spouse, perhaps each of them can take advantage of their respective capital gains deduction (Chapter 12).

B. What is he selling?

We now have to consider the details of all the property which is being sold:

1. Are there any government rights or licenses such as a milk quota? If so, special rules exist as to the tax treatment of the proceeds from the sale of such rights or licenses (Chapter 9). The income tax cost on the sale of quota has been drastically reduced as a result of the extension of the capital gains deduction to this asset.

2. How has the farmer treated his livestock in the past for income tax purposes? If he has a basic herd his tax treatment will be different from a farmer who is on the normal inventory basis (Chapter 6). It is also possible that a farmer may have a combination of a basic herd for certain types of livestock and an inventory basis for others. In this case some of his proceeds will be fully taxable and some will not.

3. How has the farmer treated his depreciable property (buildings, vehicles, equipment, etc.) for tax purposes? When he sells his assets, the tax treatment of property which has been written off on the straight-line basis (Part XVII assets) will be different from the treatment of property handled on the declining balance basis (Part XI assets) (Chapter 7). The deduction of a terminal loss on the sale of a farm building depreciated on a declining balance basis will be restricted if the land on which the building is situated is sold at a profit. This is discussed in Chapter 7.

4. Does the sale of assets include property that was a principal residence of the farmer? If so, allocations of the proceeds which relate to the principal residence must be made and a decision taken as to which of two basic methods will be followed in calculating the exempt portion of any capital gain. Care should be taken to ensure that the principal residence exemption is utilized to the best advantage (Chapter 10).

5. Are there any inventories or accounts receivable which have not previously been reported in income because the farmer always filed his tax return and reported income on the cash basis? If so, the value of such crop inventories or accounts receivable may be brought into income at the time of sale.

6. Are the assets eligible for the capital gains deduction (see Chapter 12)? Quota, land and buildings may be eligible for the deduction.

The foregoing list is by no means an exhaustive summary of the types of assets which may be sold or the tax treatment attached to them. It is merely an attempt to highlight the complexity of the tax considerations which come to light under the more general question of what is being sold.

C. To Whom?

This question is also deceiving. In our example we considered an arm's length sale to an outside party. But if the sale is made on a non-arm's length basis, some very different tax rules apply. A sale to your children, grandchildren or great-grandchildren will involve different rules again. And if a farmer is selling his assets to a corporation in which he is a shareholder, or to a partnership of which he is a member there is, once again, a different set of tax rules available. Even the sale to a third party may not be free from complications. This is particularly true if the farmer selling the property decides, for example, that the sunny climate of Arizona might make retirement years more enjoyable. If he ceases to be a resident of Canada certain reserves are not available to him.

D. For how much?

Under this question there are several other important questions which must be answered. First of all, if various assets are sold as a package, the proceeds from the sale must be allocated to each asset on a reasonable basis. It is wise to spell out in the sale agreement the sale proceeds applicable to each asset being sold. In addition, where the assets were owned at December 31, 1971, a V-day value must be determined for each asset which was owned at that time. Thirdly, the historical cost of each asset should be determined wherever this is known. Where no historical cost can be determined it will be considered to be nil. These calculations are necessary so as to determine the capital gains and losses, income gains and losses, recaptured capital cost allowance and terminal losses arising as a result of the sale. How the sale proceeds are allocated to the various assets will have a direct effect on the amount of income tax which must be paid as a result of the sale. The allocations which apply to the purchaser must also apply to the vendor. In some cases, the sale of certain moveable farming assets may involve British Columbia sales tax considerations.

E. How will payment be made and what will it be applied to?

This question does not appear to involve tax considerations at first glance. Until, that is, one considers the hardships which can arise if a person is subject to tax on income before he actually receives the cash which will enable him to pay the tax. Accordingly, in our example, where payment is going to be made over a four year period, consideration should be given to claiming a special reserve which is available to defer tax on the unrealized taxable capital gains. The availability of this reserve could have an effect on how the payment terms are structured. If payment were to be all in cash, the full amount of taxable capital gains would be taxable in the year in which the sale takes place.

A farmer's ability to claim reserves in respect of the unpaid sales proceeds has been restricted as a result of amendments to the Income Tax Act in 1981. A farmer may now claim reserves for a period up to ten years (5 years if the property is sold to a person other than his child). There are no reserves at all for sales of quota after June 17, 1987.

In certain instances it will be appropriate to specify in the sales agreement the manner in which the cash payments are to be applied among the assets sold. The vendor's objective will be to first apply the proceeds against assets which generate little or no income for tax purposes.

F. How will any unpaid balance of the sale price be secured?

Closing a deal is one thing; collecting all of your money is another. With the very substantial value of many farm operations these days a farmer who is selling out is often asked to carry the balance of the unpaid purchase price. Special care should always be taken to ensure that proper legal arrangements are made to give the best security possible to the person selling. If the farmer has to repossess the farm because of non-payment by the purchaser, he should be able to recover farm assets that are worth something more than the balance of principal and interest owing to him. Where there is a mortgage foreclosure or a repossession under an agreement for sale, special income tax rules come into play.

G. What will he do with the money?

This is also a question which should be decided partly in the light of income tax considerations. Perhaps the farmer will want to consider the purchase of a replacement farm so that he will have the opportunity of deferring part or all of the tax arising from the sale of his first farm. This is discussed in Chapter 17.

H. When did he last block average?

This factor might be important if the transaction will precipitate a substantial income because the tax thereon might be reduced significantly by electing to block average in the year of sale. Remember that the alternative minimum tax does not apply in the year a block averaging election is made. If the farmer cannot block average until next year, perhaps the sale should be delayed until then. Remember that the election disappears after 1991 in some instances, and in all situations after 1993.

I. What will be his income in the year of sale and in the next seven years?

If the sale produces a significant capital gain there is the possibility that the alternative minimum tax will exceed your regular tax liability (Chapter 13). To determine this, your accountant will need to know what your total income will be in the year of sale. In addition, he will want to assess your ability to recover this excess tax in future years and, to do this, he will need to know your income in those years.

The tax consequences to consider on the sale of a farm are many. They are also complex and this complexity can work both to the advantage or to the detriment of the farmer. For this reason, tax advice should be sought before the sale to ensure that no hardship is caused to the farmer and that use is made of every tax advantage available to him. For many farmers, the value realized when a farm is sold represents the financial accumulation of a lifetime. It is important that he enjoy the maximum amount to which he is entitled.

Chapter 17

MOVING A FARMING BUSINESS

It is not uncommon in the farming community in British Columbia for a farmer to move from one location to another. Sometimes this involves moving the entire farm; on other occasions it involves the sale of only one segment and the purchase of another. Farmers in this situation may be able to take advantage of some special tax rules.

Where a farmer acquires depreciable assets of the same class as those sold, or acquires additional quota rights, and the purchase and sale occurs in the same fiscal year, he will be able to reduce or perhaps eliminate the income inclusion that would otherwise occur in respect of recaptured depreciation and sale of quota. In the absence of any special rules, however, there would be no relief from the taxable capital gains arising from the sale of those depreciable assets or from the sale of other capital property. In addition, where the new farm assets are not acquired until the next fiscal year, there would be no relief at all from the taxation of income arising on the sale.

These potential tax problems were alleviated to some degree when the government introduced the capital gains deduction. However this deduction doesn't solve all the potential problems. It doesn't, for instance eliminate recaptured depreciation nor does it eliminate the recapture of quota write- offs. Finally, of course the capital gains deduction is of no benefit if the taxpayer is a corporation.

In recognition of the hardships faced by all businessmen (including farmers) who relocate part or all of their business operations, the federal government has provided a special rollover, referred to here as the "business replacement rollover", to soften the tax blow. The rules were not designed specifically for farmers, but many farmers will find that they can take advantage of them.

To whom do the new rules apply?

The tax deferral advantage will be available to any business operation, whether organized as a sole proprietorship, a partnership, or a corporation. The particular assets which will be favourably treated will include:

A. Real property or an interest in real property which is a capital property used to earn income from a business. A rental property such as an apartment block or any other type of rental real estate will not qualify. Parcels of land that are held essentially for resale will not qualify either.

B. Depreciable property that is a building or a leasehold interest which comes within the definition of real property or an interest therein. It should be noted that only buildings that are depreciable on the declining balance basis will qualify for this rollover.

C. An eligible capital property such as milk quota, poultry quota and similar government rights used in the business carried on by the taxpayer. Commercial goodwill owned by a business operation would also come within this category.

When will the tax deferral be available?

The tax deferral will apply in situations where a taxpayer has sold or otherwise disposed of one or more qualifying assets during a taxation year. The taxation year in which the sale occurs is referred to as the "initial year". A replacement property must be acquired before the end of the following taxation year. This means that in normal circumstances, a farmer would have a maximum of about 24 months from the date of sale of the first property to acquire the replacement

property. He could be restricted to a period of only 12 months, however, or even a shorter period if the taxation year following the "initial year" is less than twelve months.

These special rules also apply where property is expropriated, lost or destroyed. In these circumstances, an additional year is allowed for the replacement property to be acquired.

A typical example

An illustration of a situation in which these rules would be advantageous is as follows. A farmer sells land, buildings and milk quota in 1988 and acquires a similar farm in a different part of the province in 1989. He is an unincorporated farmer and has been reporting his income for tax purposes on a calendar year basis. In such a case, he would be eligible to defer the tax on the taxable capital gain on his land, the recapture of capital cost allowance on his buildings and the taxable amount of proceeds on disposition of the milk quota. The exact mechanics of the deferral, and whether or not a full deferral is obtained, will depend upon the amount of the sale proceeds for the original properties and the cost of the replacement properties.

The taxable amounts which are deferred in this way will reduce the respective cost components of the new business assets. Generally, his new land will have an adjusted cost base equal to the amount he paid for it minus the amount of the capital gain which he deferred on the sale of the old property. Similarly, the new buildings will have a capital cost for tax purposes equal to the amount paid minus the deferred capital gain on the previous buildings. The deferred recapture of capital cost allowance is deducted from the undepreciated capital cost of the new property. The cumulative eligible capital account of the new milk quota will be reduced by the amount which would have been taxable on the sale of the old quota.

Note that in our illustration we have assumed that there is a disposition of the quota relating to the first farming operation and the purchase of new quota for the new business location. We made this assumption to illustrate how the rules work, even though a sale of quota may not in fact be necessary when a dairy farmer changes the location of his operations.

What happens if you buy the replacement property before you sell the former property?

It often happens that a farmer will purchase his new farming operation before he has sold the old one. If the replacement property is still owned when the former property is disposed of, then the rollover rules will apply.

How is the income tax deferral claimed if the replacement property is not bought until the following fiscal year?

The taxable capital gain, recapture of capital cost allowance, or income arising on the sale of quota rights will have to be reported in the normal manner for the year in which the original sale takes place. When the tax return for that year is filed then any income tax which is due must be properly paid.

When the replacement property is acquired in the second fiscal year, however, then an amended tax return for the prior year must be filed claiming the advantage of the business replacement rollover.

In any situation where both transactions occur in the same fiscal year, then this refiling of tax returns is not necessary since the rollover rule can be claimed immediately.

It may be advantageous, therefore, to acquire the replacement property in the fiscal year that the former business property is sold.

What are the tests for a replacement property?

Some fairly strict guidelines apply as to what will be regarded as a replacement property. The same guidelines which govern land and buildings will also apply to eligible capital property such as quota.

The rules which will apply are as follows:

A. The replacement property must be acquired for the same or a similar use as the use to which the former property was put.

B. Where the former property was used by the taxpayer in a business, the replacement property must be used to earn income from that same business or a similar business.

C. For people who are non-residents at the time that they acquire the replacement property, certain special requirements must be met to enable Canada to tax the gain that will eventually arise on the replacement property.

It is quite clear that some of these rules will be open to interpretation depending upon the unique facts of each case. The meanings of the "same or similar use" and the "same or similar business" will be subject to particular attention by the tax authorities and tax planners alike.

Revenue Canada has indicated that the meaning of the "same or a similar business" will probably be interpreted very generously. It would appear that any activity which comes within the broad meaning of farming for income tax purposes would be considered to be the "same or a similar business" for purposes of the rollover.

The replacement property rules may be useful in a situation where a rancher wants to partially retire. The beef cattle operation that he has worked hard to build up over the years has now become too much for him and he wants to take things a little easier. He sells his land and buildings, some machinery and equipment and also his herd. Before the end of the second taxation year he buys a smaller ranch where he keeps a small herd of cattle just to keep himself active. If the figures work out, he could avoid tax on the real estate and may only have to face tax on the proceeds from the sale of cattle from his former operation.

If a farmer is able to choose between

a) avoiding a capital gain by using the replacement property rules or

b) reporting the taxable portion of the capital gain and avoiding tax by claiming the capital gains deduction

he will generally prefer the second option. If he chooses the replacement property option the cost of his replacement property will be reduced by the amount of the gain that he avoids on the sale of the first property. He will retain his full capital gains deduction but because this tax concession could be removed before he sells his replacement property, he could end up not benefiting from it. If, on the other hand, the farmer chooses the capital gains deduction option, he "locks in" his deduction before the government can take it away from him and the cost of his replacement is not reduced.

While the above comments will apply in many situations, they will not necessarily apply in a situation where a sale results in a recaptured depreciation as well as a capital gain. Here, it may be preferable to use the replacement property rules because the capital gains deduction will not apply to recapture. It may also be appropriate to use the replacement property rules if the sale is made by an individual and there could be a problem with the alternative minimum tax (see Chapter 13).

CONCLUSIONS

Farming is a very capital intensive business with the result that families who choose to earn their livelihood from this activity are often "asset rich" and "cash poor". Because of this, the minimization of expenditures, including those on taxes, is extremely important.

There are "rollover" rules in the Income Tax Act which allow families to pass their farms from one generation to the next without tax but some families have not structured their business affairs so that they fall within these rules. These "rollover" rules are perhaps less important than they used to be because of the capital gains deduction. They have not become irrelevant, however, because the capital gains deduction does not apply to all farming property and, even where it does apply, there is the possibility that the new alternative minimum tax will reduce its impact.

Many families are being placed in the difficult position of trying to preserve their farms for future generations and to provide for children who are not involved in the farm. Trying to do this in a manner that will treat all children equitably, allow the "farming children" to operate the farm and keep income taxes to a minimum, is often very difficult.

For these and other reasons it is important that farmers plan their affairs properly and receive good advice on the tax implications of their plans. They should remember that our tax laws are being updated constantly and these updates can have the effect of changing an appropriate strategy into an inappropriate one. **You may not be able to keep up-to-date with these changes but it is important that your advisers do!**